

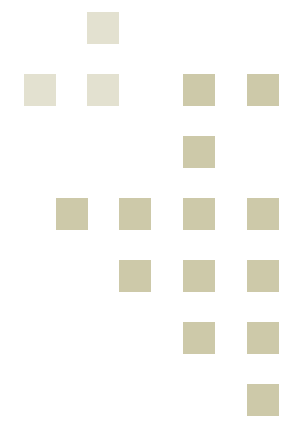


# Report



## **Experts, banks and politics** **What explains the making of Basel II?**

**Magnus Bertling Bjerke**



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# Experts, banks and politics

## What explains the making of Basel II?

**Magnus Bertling Bjerke**

**[Abstract]** The Basel Committee on Banking Supervision (BCBS) has in the course of the last couple of decades evolved to become a central arena of global economic policymaking. This committee's so far most extensive policy project is known as Basel II, and refers to the updated version of the 1988 Basle Capital Accord. The rationale of this update was to improve the capital adequacy regime governing the world's banking industries. After a long drawn policy process, starting in 1998, it was finalised in July 2006.

This paper seeks to explain the policy process behind Basel II, as seen through three theoretical lenses. The first is the theory of epistemic communities, as developed by among others Haas (1992). The second is based on the societal school of international relations, and is called Varieties of Capitalism and International Political Economy (VoC/IPE). The third is called transnational governance, and draws on concepts taken from the multilevel governance literature.

The thesis concludes that Basel II to a large extent could be explained as a result of activity from an epistemic community. This contrasts Kapstein's (1992) findings from the policy process behind the 1988 Basle Capital Accord, where no such element could be found. The VoC/IPE perspective, which is close to Kapstein's explanation of the 1988 process, does however still have explanatory value, albeit for less central parts of the new accord than those accounted for by the epistemic community perspective. Furthermore, to the merit of the transnational governance perspective, the Basel II policy process has shown to involve a multitude of actors at a variety of levels. Of particular importance were experts adhering to an epistemic community, government representatives pursuing narrow national interests, private actors from the financial industry, as well as the EU.



## **Preface**

This thesis was completed in November 2007, as a part of the requirements for my master's degree in Political Science at the University of Oslo. It was supervised by Dr Bent Sofus Tranøy (spring- and autumn semester 2007), and written at the Norwegian Institute of International Affairs (NUPI), where I was employed as a student scholar at the Department of International Economics.

My most sincere gratitude goes to Dr Tranøy for his excellent advice. I would furthermore like to thank Claes Norgren, Bjørn Skogstad Aamo and Alf Arne Hageler for their willing participation in interviews, Thorvald Grung Moe for his highly informative advice, as well as my mother, Ellen Bertling, for proof reading.

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If anyone has been left out, I am nevertheless eternally grateful. Any errors or misinterpretations are entirely my own responsibility.

Oslo, November 2007

Magnus Bertling Bjerke



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## Introduction

In July 2006, the Basel Committee on Banking Supervision submitted a final, revised draft of the Basel Accord, colloquially known as Basel II.<sup>1</sup> After almost a decade of bargaining, the member states had agreed on a new set of rules for the banking industry, substantially refining and revising the rules known as Basel I, which had been set down by the same committee in 1988.<sup>2</sup> In the years to come, legislation based on the principles of Basel II is scheduled to be implemented by a majority of the world's sovereign states. It aims to promote the stability of the global payment system, at the same time as it shall address concerns for the efficiency and profitability of the world's banking industry. The making of this accord will be the topic of this thesis.

Why write a thesis on the dreary details of international banking regulations, one might ask. One reason is the sheer scope of these regulations. Compared to its frequently demonized cousins in the World Bank, the WTO, and the IMF, the Basel Committee has had a relatively obscure position in the international public debate. Neither the big social movements, nor the media outside the realms of the financial press, have shown any significant interest in the workings of the Committee and in the consequences of the rules it makes. Nevertheless, since the agreement on Basel I in 1988, the Basel Committee has established itself as one of the key fora of global economic policy making. In so doing, it has grown to an importance not resembling anything originally envisaged (Underhill 2005). Initially, the Basel Accord was intended as a measure only for the internationally active banks of the Basel Committee member states. However, despite having no obligations to do so, also a vast number of other countries have voluntarily adopted its principles. This development could be understood on the background of the dominance of the Committee member states in the

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<sup>1</sup> In accordance with what is customary within the main body of literature on the topic, the Basel Committee on Banking Supervision will for the rest of this thesis be referred to as 'the Basel Committee' or simply as 'the Committee.'

<sup>2</sup> The Committee consists of senior representatives from central banks and bank supervisory authorities from the G10 countries (i.e. Belgium, Canada, France, Germany, Italy, Japan, the Netherlands, Sweden, Switzerland, the UK, and the US); and from Luxembourg and Spain. It congregates at the Bank for International Settlements (BIS) in Basel.

world of finance. Inasmuch as these countries account for more than 80% of the world's financial transactions, access to their markets, which include major financial centres such as London and New York, is vital for any bank with aspirations to participate in international finance. As such access is contingent on compliance with the rules of the Basel Accord, abiding to these rules becomes a necessary precondition for any country aiming to have a modern and efficient financial industry. Thus, by the early 1990's, Basel I had thoroughly left its humble origins. Its principles had come to be implemented not only by more than 100 states, but also, in the case of many countries, by all banks, internationally active or not (Pattison 2006: 444; Underhill 2005). It is by far the most extensive example of international policy coordination within the financial sphere, and possibly, in the global economy at all.

That a social phenomenon is extensive does however not in itself make it interesting. Thus, the question remains why one should worry about the Basel Committee and its policies. Two more reasons could be given. Firstly, it's a matter of consequences, derived from the nature of banking and finance itself. Already Walter Bagehot in the 19<sup>th</sup> century recognized the importance of banks in international affairs (Wood 2005: 10). As the international financial system is developing, to encompass ever more countries and areas of the world, this importance is far from declining. Recent and not-so-recent history has to the full demonstrated that the world of finance matters a lot for the everyday life and well being of ordinary people. Famously, in 1997, Japanese banks operating in the Thai market were instrumental in triggering a financial panic ravaging national economies throughout much of Asia. Most recently, as this thesis is being written, irresponsible lending in the US sub-prime mortgage market has put global financial stability at stake. Also on a number of other occasions during the last few decades, crises starting in the banking sector have spilled over to currency markets, and caused severe contractions in output, loss of jobs, and social turmoil. (Pauly 2005; Kaminsky & Reinhart 1999). The consequences of the financial crises in the inter-war era go without mentioning. At the same time, the financial market is by far the most globalised part of the world economy. While trade in goods is still the matter of strict rules set in negotiations between national governments, and the impediments to the free

flow of labour are rife, the flow of money across national borders has become increasingly difficult to control in the course of the last four decades. (Garrett 2000; Underhill 2005). In Cerny's (1993: 10) words: '...the most international, the most transnationalized and the most constraining structure in the international political economy is international finance...'. The Basel Accord was launched as an effort to enhance the stability and smooth operation of the global financial markets. In doing, or in failing to do so, the accord has implications for the entire global economy. In other words: Hidden behind the technicalities of the Basel Accord, are the jobs, pensions and future of billions of people.

As a student of politics, I am however more interested in how an economic policy is made, than in its consequences. The other reason to have a look at the Basel Accord is thus a matter of process, i.e. how the rules of the world economy are, and should be, made. Despite the elevated status of the Committee as a body of experts, the intimidating complexity of the issues it deals with, and its obscure position in the minds of most people, the development of regulatory standards in the Basel Committee is not a pure matter of technicalities. Rather, most accounts of the policy process of the first Basel Accord emphasize the role of domestic distributional concerns, diverging national ideologies, and exercise of coercive power, as key variables. (Oatley & Nabors 1998; Singer 2004). Regulatory standards, and the compatibility of these standards with the domestic financial structure, have repercussions both for the competitiveness of banks as business enterprises, as well as for the use of banks as vehicles for socially efficient allocation of capital to productive uses. Consequently, the making of bank regulations is intimately connected to distributive conflict, and hence, to politics. This brings up a number of interesting questions. An extremely important one, from a political science perspective, is the issue of legitimacy, i.e. whom the rule-makers represent. An obvious problem is the asymmetry between the narrow selection of countries represented in the Basel Committee, and the broad scope of application of its rules. Most of the countries that adopt the rules have not had a say in their making. A further problem is the accountability of policy makers, even in relation to citizens of those countries actually being represented in the Committee. National parliamentarians have played an ex-

tremely limited role in the policy process of both Basel I and Basel II; rule making has mostly been left to the respective bank regulation agencies of the member states (Underhill 2005). However, by the merit of having been appointed by popularly elected governments, also these are acting on a democratic mandate, albeit an indirect one.

More problematic is therefore the multitude of private actors involved, especially big banks and financial industry interest groups. The involvement of such actors is one of the most striking innovations of the Basel II policy process, as compared with the earlier policy efforts of the Basel Committee. Admittedly, a linkage between industry actors and national regulatory agencies is not a new phenomenon. What is unique with the Basel II policy process is, however, that private actors have been explicitly incorporated in the policy process at the international level. Hundreds of private actors contributed with comments to the three intermediate drafts issued by the Committee in the course of the policy process. Furthermore, a selection of big banks was invited to participate in workshops arranged by the Committee, mostly on topics marked by high technical uncertainty. Consequently, private actors were given channels of input to the policy process. The problem of this, from a legitimacy perspective, is epitomised by a question once asked by Louis Pauly: ‘Who elected the bankers’ (Pauly 1997). In the case of private, financial industry actors, the answer is obviously: None. Admittedly, this is not a problem per se. On the contrary, involvement of private actors might be a fully legitimate strategy to improve the quality of the information on which decision-making is based. While bank failures might have grave consequences way beyond the realms of the financial industry, bank regulations as such are concerned with relatively esoteric issues, which are only encountered by employees of the industry. (Norgren 2007 [interview]). Consequently, much of the knowledge of problems and their potential solutions is likely to be held by industry actors, which are the ones being closest to the problem in their day-to-day activity. The inclusion of these actors in the policy process thus allows decision makers to make more informed choices. As long as the only contribution of private actors is to expand the body of knowledge accessible to the policy process, their inclusion is therefore unproblematic. However, banking regulation is an intrinsically complex and technical policy area. The capacity of politicians,

and ordinary citizens, to monitor the activities of the policy makers, to which the responsibility of rule making has been delegated, is thus extremely limited. The risk of so-called regulatory capture, i.e. that the regulatory agency (i.e. the Basel Committee) becomes dominated by the interests of the industry it is supposed to regulate (i.e. the banks), is therefore looming. (Wood 2005: 126).

Rather than emphasising the normative aspect of these issues, this thesis will take a descriptive approach. As a relatively recently accomplished policy process, the history of the accord's making is still in the process of being written (see e.g. Young (forthcoming)). The thesis endeavours to contribute to this process, through the making of a theoretically informed account of the events behind Basel II. For this purpose, an empirical analysis will be undertaken, structured around three questions. The first of these, concerns *why* the accord was changed. A useful analytical concept is in this respect the distinction between knowledge and interests as alternative driving forces of policy change.

Knowledge will in this context refer to widely held technical knowledge about regulation, i.e. to shared understandings of which regulatory approaches benefits the world seen as a whole. Consequently, it centres on how to achieve a policy optimising the mix of regulatory objectives. In the case of bank regulation, these are two. The first is the concern for the stability of the international financial system. Preventing major upheavals in the financial markets should be the aim of any regulator, whether one as Kindleberger (2000) views such upheavals as an articulation of an inherent tendency of financial markets to destroy themselves, or merely as a result of poor practices by individual bankers. The second objective is efficiency, more precisely, the efficiency of banks as tools of financial intermediation. It would be perfectly possible to design a 'safe' banking system, where the likelihood of losses was negligible, for instance by disallowing lending to anyone but the lowest risks, such as rich country governments. Banks are, however, in the business of controlled risk taking. By pooling the risk of many different borrowers, and the funds of many different depositors, it is possible to channel deposits to investments without any single depositor having to carry the full

risk of any investment. This ability to assess and manage risk is what enables savings to be turned into productive investments; it is in this respect a key factor of economic growth. The challenge is therefore to design a system uniting the goal of stability with the need to maintain the efficiency of financial markets. (Wood 2005: 150)

The concept of interests, in contrast, stresses the understanding of policymaking as distributional conflict. Consequently, it is not the concern for the stability and efficiency of the overall system that matters, but the consequences for the individual actors. In other words, rather than on improving the Pareto optimum, the focus is on distribution between the players, regardless of the consequences for the stability and efficiency of the financial system as a whole.

The second structuring question of this analysis is *who*, more specifically which actors had impact on the policy process of Basel II. As briefly outlined further above in this introduction, the policy process of Basel II has involved a broad range of actors. Admittedly, the rule-making as such has largely been the prerogative of technocrats from the regulatory agencies of Basel Committee member states. However, a wide range of private actors, as well as, on occasions, national politicians, have worked towards the process in Basel, presumably seeking to influence its outcome. Getting an overview of these actors, as well as understanding their respective impact on the policy process, is thus the second objective of this thesis.

The final question to be asked is *how*, i.e. which mode the policy process followed. It will be investigated how actor influence was articulated, as well as how the dynamic interaction in the Committee contributed to shape the final outcome of the policy process.

To answer these questions, the thesis will employ three theoretical perspectives; these will be thoroughly elaborated upon in chapter 2. The first is the by now well-established concept of epistemic communities. In respect of the why-question, this concept views policymaking as being predominantly shaped by knowledge. Concern-

ing the identity of policy relevant actors, i.e. the who-question, experts interacting in transnational networks are considered at the core of the policy process. Regarding the how-question, policy is seen as being influenced through rational argumentation.

The second perspective to be employed draws on the so-called Varieties of Capitalism literature, and on standard theories of international political economy. The answer to the why-question is under this perspective viewed to be closer to the interest concept, more specifically the interest of individual countries. Diverging domestic economic structures are seen as causing diverging regulatory preferences, thus making pursuance of nationally desired regulations the key driver of policy change. Regarding the who-question, actors representing national interests are seen as being the most important ones to the policy process. Technocrats, i.e. experts, are likely to be important under this perspective as well, but rather than being motivated by knowledge (i.e. the common good of the world financial system), they are motivated by (national) interest. Furthermore, national politicians, catering for constituencies particularly affected by the regulatory change, might be involved in the policy process. In respect of the how-question, policy is being seen as influenced by power. The capacity of individual country negotiators to coerce its opponents is therefore the key determinant of the developments of the policy process.

The final concept, to be dubbed transnational governance, draws on concepts developed by the strain of international relations literature known as multilevel governance. Simply speaking, the concept views policymaking as a process being shaped by a multitude of public and private actors. These actors could be found at the national as well as at the international level, where they interact in loose, transnational networks. As an analytical concept, this is much looser than the two other theories employed by this thesis. Rather than rivalling the other concepts, it seeks to deepen our understanding of the policy process through providing complementary insights. The core rationale behind its introduction in the analysis is to explain the effects of the plethora of actors other than regulatory agency officials, which has been involved in the policy process. As referred to earlier in this introduction, a major innovation of the Basel II policy

process is the involvement of a wide range of private actors through workshops, and through comments on tentative drafts. To this could be added a potentially important influence of the EU, which was one of the findings of the interviews performed for the purpose of this thesis. For each of the questions *why*, *who* and *how*, it will be considered whether the perspective adds complementary insights.

This thesis is organised as follows: Chapter 1 will outline the basic facts of banking regulations, as well as the properties and consequences of Basel II. Furthermore, a brief summary of the history of the Basel Committee, as well as of the policy process of Basel II, will be given. The chapter will also make a brief overview over the data and method to be employed in this thesis. Chapter 2 will elaborate further on the theoretical perspectives briefly sketched out in this introduction. For each of the three questions asked about the policy process, (i.e. why, who and how), testable hypotheses will be sought developed. Finally, chapter three will use these theoretical perspectives to investigate the empirical evidence from the policy process. It will be argued that knowledge has been important in shaping the properties of the new accord, but that there has been a significant impact of diverging national interests and power exercise as well. Furthermore, it will be argued that the extensive involvement of private actors in the policy process has made a significant contribution in terms of information and policy development in areas marked by uncertainty, but that there are no evidence of any capture of the policy process.



## **1.0: Basel II: Properties, consequences and background**

The topic of this study is the political processes surrounding Basel II, not the detailed rules of the final accord, or their consequences for the global financial system. This political process could however only be understood if two aspects have first been clarified. Thus, this chapter will make some preliminary empirical investigations, necessary for the analysis, which eventually will be performed in chapter 3. The first aspect relevant to the analysis concerns the practical consequences of the change from Basel I to Basel II, both in terms of substantive changes to the accord itself, and the impact of these changes on the financial system. As this thesis analyses a policy process, these changes, i.e. the output of the policy process, must be the dependent variable of the analysis. Consequently, we could not go further before these have been thoroughly identified. The second aspect is the context of the process. Policy is not made in a vacuum. To understand the dynamics of policymaking, we therefore need to know the process' institutional, political, and historical environment. Loyal to these two aspects, this chapter is organised as follows: Part 1.1 will give a crash-course in the rationale for regulating banks, as well as define some key terms. This will be sought made as brief as possible, it is nevertheless required if we are to understand the arguments to be made in the following parts. Part 1.2 will investigate the changes entailed by the shift from Basel I to Basel II, and identify the most important features of these changes. Part 1.3 will outline the history of the Basel Committee up to the inception of Basel II. This historical account will be taken further by part 1.4, which will briefly outline the policy process of Basel II from the revision's initiation in 1998, to the submission of the final draft in 2006. Finally, part 1.5 will give an overview over the method and data to be employed in this thesis.

### **1.1: Why regulate banks?**

At least since the early 20<sup>th</sup> century, public authorities have invested significant resources in attempts to create and manage domestic rules guiding the activities of bankers. Furthermore, ever since the financial turmoil of the 1970's, there has been a grow-

ing tendency towards increased international cooperation within this policy area. Thus, it is evident that governments care about what bankers do. The question of why they care comes naturally, considering all the resources spent. Standard economic theory predicts that the presence of a market failure leads to demand for regulations. This demand is likely to be stronger the graver the consequences of this market failure are. In the case of banks and financial markets, both market failure and gravity is present. Firstly, the banking market is conducive to the type of market failure known as information asymmetry. A bit simplified, banks live of investing the depositors' money, i.e. they act as intermediaries between lenders and borrowers. Any investment entails risk, risk taking should however be controlled. Especially when the bank's investments are financed through perceived low risk products such as ordinary bank accounts, the likelihood of excessive, unexpected losses must be minimized, lest the depositors are to take losses they are not prepared for. It is therefore pivotal that bankers do not embark on excessively risky ventures. High-risk investments have, however, not only a high loss potential, but also a potential of high earnings. Therefore, as has been demonstrated repeatedly throughout history, bankers might choose to engage in high-risk investment strategies, which in essence are nothing but pure gambles. Success in such strategies would give the bank a huge pay off, while a possible failure to a large extent would be carried by the depositors, or, in the event of a government bailout, the tax payers.

This potential conflict of interest between bankers and depositors is the core target of all banking regulation. In theory, it should however not exist. After all, depositors concerned about their savings should have every incentive to keep an eye on the investment strategies of their banks. Nevertheless, considering the long history of bank failures, it is apparent that they do not. The answer to this puzzle lies in complexity. Banks are, by nature, complex businesses. Assessing them requires comprehension of complicated financial information. The problem associated with this complexity is exacerbated by the fact that banks tend to raise much of their funds from investors with limited financial literacy, i.e. from ordinary deposit holders. Outside the world of the more simplified versions of textbook economics, few of these would be able to assess

the risk associated with the activities of their bank. Unless the bank encounter trouble so serious that it is rendered unable to honour its liabilities, irresponsible investment practices are thus not likely to become known to the depositors. In other words, information is asymmetrically distributed. While bankers are likely to have a relatively high knowledge of the risks entailed by any given investments, depositors are likely to be much less informed. Thus, *ceteris paribus*, rogue bankers have significant leeway to pursue hazardous investment strategies jeopardizing the savings of the depositors.

Secondly, concerning the consequences of this market failure, the damage caused by bad practices in the banking sector might indeed be of serious dimensions. As outlined in the introduction, bank failures tend to incur massive costs on society, through loss of savings, through disruptions to the credit system, and through the cost to taxpayers associated with government rescue operations. Not only do such occurrences have adverse consequences for growth and distribution, they might also entail political costs to the incumbent government, through a backlash against government economic policies. Aside from these general costs to society, recurrent crises are likely to undermine public confidence in banks, something which would in itself be a serious impediment to an efficient operation of the financial system. Hence, preventing financial crises is a matter both of the well-being of citizens, of the efficient operation of the financial industries, of the legitimacy of the incumbent government, and in a wider sense, of the legitimacy of the whole capitalist system. The extensive government interest in bringing and keeping banks under control therefore comes as no surprise.

Having established why governments care about banks, the question of how this worry is articulated into policy comes naturally. National regulators have in the course of history experimented with a wide variety of policies aimed at preventing and/or mitigating banking sector troubles; among these are licensing requirements, deposit insurance, and reserve requirements. In the case of the two Basel accords, the focus has been on so-called capital adequacy. The term itself refers to a bank's capital (i.e. shareholder equity and retained earnings) as a percentage of its assets (loans and other claims). Focusing on such a ratio has two functions. Firstly, mandating a certain ratio

to be kept imposes a cost on banks issuing assets, by requiring an expansion in assets to be matched by raising more capital. The rationale behind is to counter tendencies to boom and bust cycles in lending, by limiting the growth of the bank's portfolio to what could be matched with capital. Secondly, capital adequacy should ensure that the banks are able to cover unexpected losses. To properly understand this concept, it is useful to visualise a balance sheet, where assets are backed by liabilities and shareholder equity.<sup>3</sup> Banks are, as all firms, financed through a combination of equity and debt; the latter does in the case of banks mostly consist of deposits made by clients. There are, however, two noteworthy features about the financing of banks. Firstly, the share of equity is much lower than what is common in non-financial firms. Secondly, the financing of banks entails an inherent inconsistency, inasmuch as the major share of a bank's debt (i.e. deposits in demand accounts) has no fixed maturity, and thus could be withdrawn without advance notice. The bank's assets (i.e. loans) could in contrast not be called back before the date stipulated by the lending contract. Hence, banks are inherently backing most of their long-term assets with short term debts, and are as a result in a constant situation of maturity mismatch.<sup>4</sup> (Steil & Litan 2006: 16-17).

In itself, this is actually less of a problem. Under normal circumstances, all deposits will not be withdrawn simultaneously. Furthermore, with proper risk management, the interest rate spread between the rates paid to depositors, and those collected from borrowers, should be enough to cover both *expected losses* and a profit for the bank. However, a problem might arise in periods of financial distress, when loan default rates are higher than expected, i.e. the *unexpected losses* go up. Unless the bank has a buffer of equity capital, these losses might depress the value of the bank's assets below that of its liabilities, i.e. it becomes insolvent. Focusing on capital adequacy could thus best be understood as a tool to promote bank solvency; a goal which is attained through three mechanisms. Firstly, by keeping uncontrolled asset growth in check,

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<sup>3</sup> A balance sheet must follow the following formula: Assets = Liabilities + Shareholder equity

<sup>4</sup> Maturity mismatch indicates that liabilities have a shorter maturity than assets; this could potentially cause a liquidity crisis.

banks are prevented from building up too high exposure in boom times. Thus, they are less likely to encounter solvency problems when the economy moves into a recession. Secondly, keeping a cushion of equity capital increases the capability of the bank to absorb unexpected losses, and thereby reduces the need for a costly government rescue operation. Thirdly, adequate capital levels signals that a bank is capable of meeting its obligations even during a time of crisis, and thereby, that there is no need to withdraw deposits. By so doing, it prevents a looming threat of insolvency from becoming a self-fulfilling prophecy through a bank run (Steil & Litan 2006: 16-17).

While banks admittedly have an enlightened self-interest in staying solvent, the cost of capital works in the other direction, pushing banks away from keeping a sufficient ratio. This is especially true in strongly competitive financial environments, where banks have to cut costs to offer competitive interest rates. Thus, the aforementioned problem of market failure prevails, and there is room for government action to ensure that an adequate level of capital is kept. In general, the government's tools to govern banks could be categorised in three groups: Regulation, supervision, and use of market mechanisms.<sup>5</sup> Regulation refers to the legal framework governing market entry as well as market activities, i.e. legally enforceable rules prescribing and proscribing various actions. Supervision refers to the banking supervisory authority's oversight of the banks' activities. In contrast to regulation, it describes a mode of direct interaction between banks and regulators; through off-site examination of balance sheets, and through on-site inspections of day-to-day banking activity. (Wood 2005: 6). Use of market mechanisms does not refer to inaction from public authorities, but rather, active measures taken to strengthen market discipline. This could include e.g. requirements to disclose information (e.g. in the public accounts), which would allow depositors to make more informed judgements about a bank's true condition. Both Basel accords utilized regulations, by prescribing a minimum capital requirement. Basel II does in addition employ both supervision and market mechanisms. The next section of this paper will outline how the concern for capital adequacy has been articulated in the

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<sup>5</sup> In much of the literature, the three concepts are blended together under the term 'banking regulation'. When others is not explicitly stated, this use of terms will be employed in this paper as well, with 'regulation' referring to the general process of bank sector governance performed by public authorities.

change from Basel I to Basel II, how the three governance mechanisms have been incorporated, and what the new accord entail compared to the old.

## **1.2: From Basel I to Basel II: Changes and their consequences**

As a rather intimidating document of 347 pages, Basel II constitutes a significant evolution of its predecessor. While still being a framework agreement, open to local variations in implementation, it nevertheless encompasses back-breaking detail compared to Basel I. However, to the solace of the reader, it is for the purpose of this study sufficient to concentrate on some overall, particularly important features. As the motivation of the present thesis is to explain the policy process behind the accord, it is important to identify the parts of Basel II that are of particularly importance to the understanding of this process. These are, on the one hand, elements which have consequences for the overall operation of the global financial system, and, on the other, those which have particular repercussions for individual actors. The challenge is in other words to identify what is at stake. In so doing, we could develop a better understanding of the motivation of the actors.

The change from Basel I to Basel II involves changes both in terms of the scope of governance measures employed, as well as in the nature of these measures. Concerning the first issue, i.e. scope, the new accord takes a much broader approach than Basel I. That accord focused narrowly on minimum capital requirements. In so doing, it based itself on regulation in the true meaning of the word (see part 1.1). Basel II is in contrast guided by the principle of three interconnected governance pillars. These are, in addition to minimum capital requirements (which constitutes pillar 1), known as *supervisory review* (pillar 2), and *market discipline* (pillar 3). (Basel Committee on Banking Supervision 2006). By introducing these three pillars, Basel II expands the number of governance mechanisms employed. Regulation in the strict meaning of the word is through the first pillar still prominent. However, by the merit of its second pillar, the accord has in addition become more explicit on supervision. Finally, through

pillar 3 – focused on encouraging market discipline – the accord has explicitly incorporated governance through market mechanisms.

To clarify the second issue, i.e. the nature of measures employed, a thorough investigation of the properties of the three pillars is required. Concerning Pillar 2 and 3, i.e. supervisory review and market discipline, this is relatively straightforward. Pillar 2 emphasizes improvement of banking practices through structured dialogue between banks and national regulators, but also mandates regulatory intervention when necessary (e.g. by demanding capital levels higher than the minimum requirement). It requires national agencies to supervise their country's banks, and outlines indicators for sound banking practice to be used as a base for this supervision. The pillar complements pillar 1 by establishing guidelines for implementation, as well as considering regulatory gaps (Basel Committee on Banking Supervision 2006: 204-223). Pillar 3 requires banks to disclose relevant information. According to the letter of the accord, the rationale behind this strategy is 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' (Basel Committee on Banking Supervision 2006: 226). The pillar thus aims at enhancing good banking practices through using market mechanisms to impose discipline.

Pillar 1, minimum capital requirements, is more technically complicated, and therefore requires a more thorough explanation. Minimum capital requirements are under both Basel accords defined as a proportion of capital to *risk weighted* assets.<sup>6</sup> By including risk weights, capital levels should better reflect the risk of losses entailed by the portfolio, at the same time as banks are given an incentive to invest in safer assets. The average capital level required, and the definition of capital, is roughly the same under both accords. Hence, the central innovation of Basel II concerns risk weighting. Risk weighting under Basel I was a crude system based on five categories known as risk buckets. Some rather superficial criteria were used to allocate assets between these

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<sup>6</sup> Mathematically, capital adequacy ratio under the Basel accords (CAR) could be described as:  $CAR = \text{Capital} / \text{Risk weighted assets}$

buckets, such as private sector assets vs. public sector assets, and asset from OECD countries vs. those from non-OECD countries. Dependant on in which bucket an asset was allocated, it was given a risk weight between 0% and 100%.

In the course of the early 1990's this system increasingly came to be seen as excessively crude and rigid, thus sparking a debate over the need for change. Three issues were of particular importance. Firstly, banks and academics alike worried that crude weights impeded banks from utilizing the increasingly sophisticated methods of risk-estimation developed in the course of the 1980's and 1990's. By ascribing a 100% risk weight to all loans to private companies, the rules occasionally led to rather absurd practices, such as requiring the same risk weight for a loan to a hot dog stand or a technology start-up, as for one to a rock solid blue chip company. Secondly, the accord to a considerable extent failed to reduce uncovered risk exposure, due to certain loopholes in the regulation. A bundle of practices collectively known as *Regulatory Capital Arbitrage* (RCA), allowed the banks to reduce capital levels, without reducing exposure to risk. Central among these was the possibility to securitize loans (i.e. to sell them in the capital market), a practice especially exploited by certain American banks. Through securitizing the least risky assets within each risk bucket, while keeping the worst risks on the books (where they wouldn't count for a higher risk than that prescribed to the bucket), banks could fill up their portfolios with high risk assets, without increasing capital levels to compensate for the extra risk incurred. Consequently, banks were encouraged to become excessive risk takers, an obvious violation of the accord's intentions. (Goodhart 2002: 26; Jones 2000). Thirdly, by ascribing a 0% weight to loans to OECD central governments, the accord gave incentives for redirecting lending towards the public sector of rich countries, at the expense of the private sector, and of developing countries.

To lose up the rigidity and crudeness of this system was an explicitly stated objective of the Basel II process. The reform effort was thus to focus extensively on bringing capital requirements more in line with underlying asset risk. In contrast to its predecessor, Basel II therefore allows choice between several alternative ways of treating asset



risk. Furthermore, while Basel I focused exclusively on credit risk, two more risk types became incorporated as a part of Basel II<sup>7</sup> (see the appendix to this thesis for an explanation of the various risk types).

Concerning credit risk, banks are given three alternatives: The Standardized Approach, the Foundation Internal Ratings Based Approach (Foundation IRB), and the Advanced Internal Ratings Based Approach (Advanced IRB).<sup>8</sup> The first of these, the Standardized Approach, ascribe risk weights to assets based on assessments from an external credit rating agency.<sup>9</sup> Unrated assets are normally given a 100% weight, which approximately equals the weighting ascribed to BB rated assets. AAA rated assets obtain a much lower risk weight, while B- and lower are weighted above 100%. The second approach, the Foundation IRB, does in contrast allow banks to perform asset ratings themselves, through the use of proprietary models. The same principle, albeit through more sophisticated and risk sensitive methods, applies to the third approach, the so-called Advanced IRB. (Basel Committee on Banking Supervision 2006: 31-143).

Concerning market risk, the concept Value at Risk (VaR) is to be used. This is a technique based on analysis of historical trends and volatilities, which estimates the maximum amount at risk to be lost from an investment. Here as well, the choice between a Standardized Approach and a (more sophisticated and risk sensitive) Internal Models Approach is allowed. (Ibid: 157-204).

Finally, the accord establishes three strategies for dealing with operational risk. These are known as the Basic Indicator Approach, the Standardized Approach, and the Advanced Measurement Approach, respectively. Also for these, the level of sophistica-

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<sup>7</sup> Market risk was first incorporated through a 1996 amendment to Basel I, before the start of the Basel II process.

<sup>8</sup> Which bank will be allowed to use which approach is up to the discretion of national regulators. No banks will be allowed to implement the Advanced IRB before January 2008.

<sup>9</sup> An external credit rating agency is a private company assessing the creditworthiness of companies and even countries. Prime examples of these are Standard & Poor's, Moody's and Fitch Ratings. The agencies normally utilize a scale originally developed by Standard & Poor's, which ranges from AAA (highest credit worthiness) to D (default), with plus- and minus signs added.

tion and risk-sensitivity differs. The simplest alternative, the Basic Indicator Approach, prescribes banks to hold capital equalling 15% of the positive annual gross income for the three preceding years. The slightly more sophisticated Standardized Approach discriminates between eight different business lines (e.g. corporate finance, commercial banking etc.) which each require different capital charges, between 12% and 18%. Resultantly, the method is more risk sensitive. The most advanced alternative, the Advanced Measurement Approach (AMA), allows banks to use their own risk modelling to calculate capital requirement for any given portfolio. (Ibid: 144-156).

Although it is not intended that Basel II should cause a reduction in average capital levels as compared to Basel I, the IRB approaches to credit risk, the Internal Models approach to market risk, and the Standardized and AMA approaches to operational risk, entails the possibility of a reduction in required capital. The reasons behind are two. Firstly, it is a natural consequence of the more fine scaled (and thus presumably correct) nature of risk weighting under the new accord, which will allow banks with a relatively low risk portfolio to reduce their capital, compared to what was required by the old, crude framework. Secondly, capital calculations are intentionally biased in the favour of banks employing more advanced approaches. Developing the proprietary models required by these approaches is expensive. Thus, the accord aims at giving banks an incentive to engage in model development by giving a pay-off in terms of lowered capital requirements for banks adopting more advanced approaches. (Norgren 2007 [interview]).

It is in this context important to keep in mind that a high capital level is not a goal per se. Only inasmuch as it contributes to the stability of the financial system, is a given level of capital meaningful. However, a reduction of capital inherently entails the risk of cutting too much, thereby eroding the buffer intended to ensure solvency in a situation of high unexpected losses. Thus, it must be ensured that a reduction of capital actually is preceded by a real improvement in risk management, lest the stability of the financial system is to be jeopardized. The techniques required for the advanced approaches are technically complex, and are dependent on a high skill level in the banks

employing them. To prevent banks with insufficient risk management competencies from employing these potentially destabilising techniques is therefore pivotal. Thus, a bank intending to use the more advanced techniques must obtain permission from the national regulator. Only the biggest and most sophisticated banks are likely obtain such. (Basel Committee on Banking Supervision 2006: 88; Economist 2006).

The technical nature of the paragraphs above makes it easy to drown in the detail, and thereby to miss the wider implications of the shift to Basel II. As outlined earlier in this part of the thesis, the motivation for investigating the properties of Basel II is to understand its consequences for the global financial system, as well as for individual actors, for thereby better to understand what might have motivated policymakers. To return to this core task, it is useful to analyse the substance of the new accord further, to extract some broader concepts. These could be found both at an abstract level, and at a more practical one. At the abstract level, we could identify five concepts, which are particularly suited to illuminate the changes from Basel I to Basel II. These are shown in table 1 on the next page.

**Table 1: Differences between Basel I and Basel II**

	<b>Basel I</b>	<b>Basel II</b>
<b>Treatment of risk</b>	Crude, relatively insensitive	Sophisticated, sensitive
<b>Approach to governance</b>	Government unilateralism	Interactivity government-market
<b>Governance tools employed</b>	Regulation	Regulation/Supervision/Market
<b>Nature of regulations</b>	Rigid	Flexible
<b>Locus of decision-making</b>	Government agencies	Government agencies and markets

The first concept concerns the treatment of risk. As mentioned, increased risk sensitivity was an explicitly stated objective of reforming Basel I. The risk weighting used to calculate required capital under Basel II is, as shown in the paragraphs above, much more sensitive to the risk profile of individual assets than what was the case with the preceding accord.

The second concept concerns the overall approach taken to governance. The mode employed by Basel I could be classified as government unilateralism, relying extensively on a traditional command and control approach. Uniform regulations were made and interpreted by public authorities, and supervision relied heavily on ex post assessment of capital ratios. Basel II does in contrast take a much more interactive approach. While the rules of the accord, and their interpretation by government agencies, still have decisive influence on how banks should treat asset risk, the details of this treatment is no longer decided by the regulatory agency alone. In accordance with the Standardized Approach to credit risk, private credit rating agencies have important impact on the risk weight to be ascribed to any given asset. In the case of the approaches utilizing proprietary models, the banks themselves are granted these powers. Thereby, the industry takes an active part in the process of working out regulatory guidelines. Furthermore, concerning supervision, the second pillar makes structured dialogue between banks and supervisory agencies an explicit policy objective. Hence, supervision is moving away from a mere focus on ex post assessments, and towards a continuous interactive process.

The third concept concerns which tools are employed in the effort to promote capital adequacy. Basel I focused only on minimum capital requirements, i.e. regulation in the narrow sense of the term. Basel II is in contrast explicit both on regulation, supervision, and market discipline, thereby significantly expanding its approach to governance.

The fourth concept concerns the nature of regulations (still in its narrow meaning, as defined in 1.1). Basel I was relatively inflexible, in the sense that a wide range of assets with wildly different risk profiles were meshed into the same risk buckets, on the basis of some rather superficial criteria. Furthermore, it prescribed one mode of risk treatment as mandatory for all banks. In contrast, Basel II not only allows asset risk to be treated at an individual basis. It also allows the choice between alternative strategies for doing this assessment, e.g. the distinction between the Standardized Approach and the IRB approaches to credit risk. The flexibility to adapt to the profiles of individual banks has thus become much larger.

Finally and in many ways as a result of the four other characteristics, Basel II constitutes a decentralization of decision-making, from government agencies to private actors. Consequently, the locus of decision-making has shifted. Admittedly, the power to make and implement regulations still lies firmly in the hands of government actors. Thus, there is no privatisation of authority as such. However, in terms of ability to influence the framework through which banks are governed, it is evident that the private sector has become strengthened. Through increased participation in the supervisory process, and not at least through the ability to influence risk weights and methodologies, private actors now have channels of influence which were absent under Basel I.

These five abstract concepts could be further analysed, to draw some more practically oriented conclusions about the implications of Basel II. An obvious question to ask in this respect is Susan Strange's famous *cui bono*; 'who benefits'? (Strange 1988). Certainly, it would be to the benefit of everybody if Basel II contributes to create a more stable and efficient financial system. Of greater interest for a political economy analysis are however private gains derived from the new accord, i.e. benefits accruing to some actor groups, but not all. In the case of Basel II, two classes of such benefits are of particular interest. These are, respectively, autonomy gains and financial gains. The first, i.e. effects of Basel II on the autonomy of different actor groups, are already implied by table 1. Through the shift from Basel I to Basel II, the approach to governance has become more interactive, actively involving industry actors in a sphere formerly

being reserved for the government. Real ability to influence the framework through which banks are governed is thereby to a certain extent decentralised to banks and credit rating agencies. Market actors thus benefit through obtaining a greater say in how they should be regulated and supervised.

The second concept, private financial gains of Basel II, is connected to the possible reduction of capital entailed by the more advanced risk management approaches of the new accord. Although overall capital levels in principle should not change, a redistribution between banks in terms of capital requirements is almost certain to occur, and is indeed intended. Banks developing more efficient risk management should be compensated, by being allowed to reduce capital to better reflect the risk of their portfolio. However, the access to employ advanced approaches to capital calculation is not equal to all banks, but subject to approval by the regulator. As already mentioned, only big and sophisticated banks, predominantly in developed countries, are likely to obtain such permission. Thus, financial resources are going to be redistributed as a result of the new Basel accord. Having identified the consequences of Basel II, one of the few things remaining before we could embark on an analysis of the policy process, is to clarify the historical and institutional context surrounding the making of Basel II. This will be the issue in focus in the two following parts of this chapter.

### **1.3: History of the Basel Committee: The long road to Basel II**

With only a few pages available, doing justice to the long and complex history of the Basel Committee on Banking Supervision is a near impossible challenge. Spanning four decades, encompassing several international agreements, and involving a wide variety of actors, the effort of the Basel Committee has in its scale, scope, and duration an unmatched position among attempts to create a system of governance for global financial markets. Nevertheless giving it a try, the first step towards understanding the history of the Committee is to investigate the rationale of policy coordination. Why national government regulate banks, has already been outlined in part 1.1. The ques-

tion of why this should be done at a level above that of the nation state does however remain unanswered. Two answers could be given, answers which both derive their logic from the increased transnational integration of the global financial system.

The first draws on mere technical features of regulation, and is a consequence of the jurisdictional incongruence arising when (largely) non-integrated political systems struggle to regulate highly integrated financial markets. As demonstrated by the closure of the German Herstatt Bank in 1974, the actions of regulators in one jurisdiction might have adverse consequences for actors abroad.<sup>10</sup> Furthermore, existing national regulations have on several occasions been an impediment to the effective supervision of local branches of banks operating in foreign markets. One example is German legislation, which for a long time explicitly prohibited the BaKred (the former German regulator) from collecting information about the foreign operations of German banks. Another is the strict secrecy laws of certain countries, which banned national regulators from sharing information with foreign colleagues (Kapstein 1991: 6). Hence, sticking to pure national regulation and supervision of banks operating in globalised markets, entails the risk of leaving parts of the financial industry in a jurisdictional limbo. This might allow foul practices to develop in foreign branches, which might again trigger distress spilling over to the mother institutions, and to the wider financial system.

The second answer is in its nature political, and related to the problem of free riding. Regulations entail costs for the banks. These could, as in the case of capital adequacy rules, be the cost of holding capital,<sup>11</sup> or simply increased administrative costs. Higher

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<sup>10</sup> On 27<sup>th</sup> June 1974, German regulators closed the Cologne based private bank Bankhaus Herstatt. The bank had incurred huge losses on currency speculations in what essentially was a 1970's version of the infamous Barings Bank scam of 1995. Herstatt was closed at the end of the German business day; due to the time zone differentials, the US markets had at that point in time not yet opened. The bank had on its last day collected receipts in Europe, intended to be paid to its American recipients the following day. Due to the closure, these obligations were never honoured, causing huge losses for US actors with claims against the bank. The incident gave name to the so-called "Herstatt risk" i.e. the risk of a business partner not honouring his part of the agreement after a payment has been made. It furthermore made evident the problems caused by uncoordinated actions by national regulatory agencies, and thus spurred the establishment of the Basel Committee. (Schumacher 2000).

<sup>11</sup> The cost of capital requirements (besides pure administrative costs, e.g. of calculating necessary capital for any given portfolio) could be categorised in two groups. The first is the cost of acquiring capital. Whether capital

costs mean lower profit margins and/or higher prices, giving a competitive advantage to those banks not having to cope with equally strict regulations. As money travels largely unimpeded across national borders, allowing domestic savers to invest where returns are highest, there is a prospect of strongly regulated (and thus high cost) banks losing out to less regulated ones. Hence, a country implementing a regulation to address a problem in the banking market, and by so doing causing extra costs to its domestic banks, has an interest in imposing the same regulations on foreign operators, to prevent its domestic banks from losing business. (Oatley & Nabors 1998; Singer 2004). International harmonization is thus both a question of efficiency, and of the distributional consequences of (asymmetric) regulations.

Having the logic of international policy coordination in mind, we could now proceed to a brief summary of the history of the Basel Committee. Its roots could be found in the rapid development of international finance from the 1960's and onwards. As the post-war order of the Bretton Woods system was gradually undermined by the growth of the Eurodollar-markets,<sup>12</sup> and later, by large-scale liberalisation of capital movements, certain indications of deep reaching problems with the existing regulatory structure became evident. Firstly, regulatory caveats, arising from insufficient control with the foreign activities of banks, increased the likelihood of bad practices to develop. Secondly, international integration increased financial interdependence. A natural consequence of this was a larger probability of any given crisis spilling over from one country to another. 1974 alone saw two severe bank failures with cross-boarder consequences. One of them was the aforementioned Herstatt crisis, the other the downfall of the New York based Franklin National Bank, which fell victim to shady foreign

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is raised in the market or through retained earnings, it could only be acquired at a cost. The second is the opportunity cost of forsaken lending. With capital requirements in place, lending is restricted by the amount of capital the bank at any given moment could raise.

<sup>12</sup> The term Eurodollar markets refers to dollar-denominated deposits in banks outside the US. Originally being a result of a Chinese and Soviet desire to deposit their dollar holdings in jurisdictions outside the reach of the American government, the growth of this financial instrument was significantly enhanced in 1958, when the British government in a bid to re-establish London as a finance hub freed deposits made in currencies other than the sterling from the capital controls otherwise applicable. As a result of this, the Eurodollar markets developed as a separate financial system, outside the reach of conventional regulation, contributing to the gradual undermining of the capital-control-based system of international financial governance developed after WWII (Wood 2005: 27-28)



transactions possibly involving the Italian Mafia. As a result of these two crises, in late 1974 the central bankers of the G10 countries agreed upon forming the Basel Committee.<sup>13</sup> (Wood 2005: 52-67).

The inception of the Committee was in other words a testament to the challenge posed to regulation by jurisdictional ambiguities arising from the increased internationalization of banking. Consequently, its first task became to clarify these ambiguities, that is, to establish rules for how the regulatory responsibility for cross-border banks should be shared between home- and host country authorities. This challenge was met already in 1975, through the issuance of the so-called Basel Concordat, a set of agreements on information sharing and division of responsibility. Although being seriously tested by incidents such as the BCCI scandal of the late 1990's,<sup>14</sup> and having been subject to significant changes and refinements (in 1983, 1990 and 1992), the Concordat is still standing as a key document of international financial regulation. (Wood 2005: 52-67).

Changing G10 country regulatory practices through the Concordat was in itself a remarkable achievement. The Committee was however soon to spur even more significant changes to the international financial architecture. The Latin American Debt Crisis of the early 1980's proved to be instrumental in this respect. Although the direst consequences of this crisis were felt by governments and citizens of the debtor countries, the crisis also entailed a serious threat to American financial markets and to the stability of the international financial system as such. In the absence of government support, the massive losses incurred by American banks would likely have triggered a credit crunch, with predictably dismal consequences for the world economy. Support

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<sup>13</sup> The formation of the Basel Committee came much as an extension of an established practise of monthly meetings between G10 central bank governors. These had taken place since the early 1960's at the Bank for International Settlements (BIS), an international organisation with roots in the interwar era.

<sup>14</sup> The Bank of Credit and Commerce International (BCCI) was an international bank set up in 1972, based in London and at the Cayman Islands. Being designed with a deliberately complex management structure, the bank soon became a regulators nightmare, and later proved to have been deeply involved in money laundering and terrorist finance. The Bank of England's inaction towards early warnings of the shady dealings of BCCI, its cover-up of the bank's solvency problems, and its denial to share information about the bank with the Federal Reserve, was a violation of the spirit and letter of the Concordat, and became a serious strain to the relationship between the British and American regulators. The incident spurred a revision and strengthening of the Concordat in 1992.

(on the expense of the tax payers) was in the end granted by the American Congress, but only with certain conditions attached. The most important of these were demands for minimum capital requirements; initially a minimum capital to assets ratio of 5.5% was set. (Kapstein 1991: 17). This move was however to cause widespread discontent among American bankers. As long as banks in other countries, particularly in France and Japan, faced much lower capital requirements (and hence costs), strengthened standards only for American banks distorted competition. Thus, as thoroughly described by among others Kapstein (1991), American regulators faced increasing pressure to 'level the playing field', meaning an extension of the American rules to other countries. Having already become a key forum of international financial governance, the eyes of the Americans soon fell on the Basel Committee as a possible vehicle for transferring American capital adequacy regulations to the rest of the world.

Noteworthy, we could here recognise the 'political' answer to why regulations are coordinated, as was outlined in the paragraphs above. Admittedly, an apparent erosion of bank capital levels in the course of the 1980's, and an increase in the activity of G10 banks in emerging market- and developing economies, strengthened the case for adopting minimum capital adequacy standards. The perils of undercapitalized banks operating in unstable offshore environments became all too evident during the Latin American Debt Crisis. However, there was no consensus among the Basel Committee member states on the necessity of international coordination of such standards. On the contrary, countries such as Japan and Germany claimed that their unique financial systems, marked by long term and close relationships between banks and debtors, made the imposition of uniform capital adequacy standards undesirable. Hence, the conditions for reaching an agreement were in the mid 1980's not at all promising. (Oatley & Nabors 1998: 42-49).

Nevertheless, in 1988 the Committee member states signed an agreement on harmonization of capital adequacy standards, which came to be known as Basel I. On the background of the abovementioned deadlock, this seems surprising. Behind the breakthrough was some cunning political manoeuvring by American regulators. Realising

the dismal prospects of reaching an agreement within the Committee, the Americans engaged in secret negotiations with the UK, to create a bilateral accord. This was possible, since the British themselves had enacted domestic capital standards similar to the American ones, and therefore were equally keen on offsetting the competitive advantage of less regulated foreign banks. Thus, on 1<sup>st</sup> January 1987 the two countries could present an international agreement on capital standards as a *fait accompli*. This completely altered the bargaining position of the other Committee members. Due to the dominant status of London and New York in international finance, the mere possibility of restricting access for banks from countries not joining in on the US-UK agreement was enough to force the rest of the Committee members to rethink their stances. Thus, the bilateral agreement between UK and US did soon become a trilateral agreement also encompassing Japan, admittedly with certain changes, to accommodate the special situation of Japanese banks. Finally, on 10<sup>th</sup> December 1988, an agreement was struck with the rest of the Committee. By incrementally building alliances outside the Committee, the Americans had managed to break the deadlock within it, and thereby enabled the birth of the first Basel Accord. (Kapstein 1991: 19-24).

According to this new accord, capital was to be held at a rate of 8% to risk weighted assets. Some rather crude risk-weighting was incorporated, categorizing assets in five groups with weights between 0% and 100% ascribed. As already outlined in part 1.2, this system showed to have serious shortcomings. Basel I was therefore soon to be heavily criticised by industry actors and academics, and it became increasingly clear to regulators that changes were needed. Such changes were indeed to come; first as amendments to the existing accord, of which several were introduced in the years following 1991. However, in 1998 a growing consensus had developed on the necessity of initiating a full-scale revision of the accord. In the words of one regulator quoted by Wood (2005: 129), Basel I had become ‘useless for regulators and costly for banks’. In June 1998 William J. McDonough, president of the Federal Reserve Bank of New York, was appointed as new chairman of the Basel Committee. This change of leadership was to push the Committee even further towards a revision of the accord. Thus, in

September that year, a working group led by Claes Norgren of the Swedish Financial Supervisory Authority was set down to undertake a comprehensive review, a review which was to result in a new accord.<sup>15</sup> (Ibid). The policy process behind this new accord will in chapter 3 of this thesis be analysed from several theoretical perspectives. First, a brief overview of events is however required; this will be the topic of part 1.4.

#### **1.4: The policy process of Basel II: An overview<sup>16</sup>**

The making of Basel II was from its very beginning intended to be an open process. Thus, rather than letting policymaking be a matter solely of negotiations between government representatives, the Committee made an effort to reach out to a wider range of stakeholders. Two measures were at the core of this effort. Firstly, the Committee adopted an interactive approach of issuing preliminary drafts, known as consultative packages, or consultative papers. Relevant stakeholders were encouraged to comment upon these reports; the comments given were to provide input for the further policymaking process. Secondly, at a lesser scale, the Committee arranged workshops involving financial industry actors. These workshops were particularly concerned with topics characterised by technical uncertainty, such as operational risk, and securitization. (Norgren 2007 [interview]). The open nature of the policy process was further strengthened by a plethora of press releases and explanatory notes issued between the major consultative packages.

The Committee had initially set April 1999 as the deadline for the first consultative package. However, the report did not emerge before June that year. The reason for this was, in particular, controversy emerging over four issues: Use of external rating, weighting of commercial mortgages, weighting of so-called *Pfandbriefe*, and techniques to measure collateral. The first, external rating, refers to the intention of the Standardized approach, i.e. to use assessments from risk rating agencies to calculate

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<sup>15</sup> The full name of this working group was ‘the Basel Committee’s Task Force on the Future of Capital Regulation’

<sup>16</sup> See table 2 at the end of this chapter for a chronological overview.

capital. At the core of this conflict was inter-country differences in the prevalence of such ratings, and the prospect of rated assets on average receiving a lower capital requirement than unrated ones. A high proportion of rated assets was at the time a predominantly American phenomenon; thus, other member states, and particularly Germany, voiced scepticism towards a system treating rated assets too favourably over unrated ones. (Wood 2005: 129-137).

Secondly, and even more important, was a controversy breaking out over commercial mortgages. Although such loans generally are considered a lot more risky than residential mortgages, German regulators had adopted a practice of prescribing the same, favourable risk weighting to both. The Americans viewed this as an irresponsible practice, and as a competitive disadvantage to American banks facing stricter rules. The Germans, in contrast, claimed a long record of stability in their commercial mortgage market, and saw no need to change. This proved to be one of the most bitter disputes of the whole Basel II process, and inability to reach an agreement on this issue in due time was the direct cause of the decision to postpone the submittance of the first consultative package from April to June. (Wood 2005: 129-137).

The third controversy was related to the weighting of Pfandbriefe. This is a type of covered bond unique to Germany; according to German rules, such bonds required only a ten percent risk weighing. Similar to the row over commercial mortgages, other member states, especially US, UK and Italy considered this provision of the German rules to be unfair competition. (Ibid).

The final controversy was connected to a British desire to include advanced mathematical techniques to measure the value of collateral. Perhaps as a result of the highly sophisticated nature of the City of London, the FSA (the British regulator) viewed such provisions as both necessary and feasible. Most other delegates did however not, and considered the suggestion to be both unnecessary and excessively complex. (Norgren 2007 [interview]).

The 62-page document finally submitted, outlined the broad principles of a new accord, including the three pillars (see part 1.2). It explicitly recognised the need to bring regulatory capital requirements more in line with underlying asset risks, as well as the belief that financial innovation had led to improvements in risk measurement and control techniques. The draft furthermore aired intentions of establishing provisions for the use of internal ratings (IRB), of including external ratings in the Standardized Approach, and of expanding the number of risk types accounted for to include among others operational risk. The consultative package was permeated by the intention of working with the market, rather than controlling and subduing it. In accordance with the open approach to policymaking adopted by the Committee, stakeholders in the industry, and among the world's regulators, were invited to comment upon the ideas. During the one and a half years to follow, the Basel Committee continued its work on refining the rules further, taking the received comments into account. (Basel Committee on Banking Supervision 1999).

In January 2001, a second consultative package was submitted. With more than 500 pages, this draft was considerably more detailed than its predecessor, particularly in its elaborations on the technicalities of risk weighting. The IRB approach was further refined, among others establishing the distinction between the foundation and advanced versions of this approach to capital calculation. Operational risk was emphasized as the major type of 'other risks' (i.e. other than credit and market risk). (Basel Committee on Banking Supervision 2001).

Again, the Committee invited comments, receiving more than 250 contributions from the industry, regulators and academics. The IRB approach, and the treatment of operational risk, proved again to be central topics of the discussions. However, also new issues were added to the debate. Most importantly, the effect of the new framework on the lending to small and medium sized enterprises (SMEs), emerged as a major controversy. The Europeans, and particularly the Germans, feared lending would be oriented away from this sector, due to higher required capital charges for claims on SMEs. Indeed, this dispute threatened to derail the whole reform process. In October

2001 German chancellor Gerhard Schröder openly announced that Germany would not implement Basel II, unless something was done to the treatment of SMEs. To save the process, the Committee eventually yielded to German pressure. In a July 2002 press release it confirmed its intentions of allowing banks using one of the IRB approaches to ascribe a reduced capital charge to SMEs, defined as companies with less than Euro 50 million in annual sales. (Wood 2005: 141).

Similarly, academics and developing country policy makers worried about the impact of the new framework on least developed countries (LDCs). Especially the incorporation of credit rating agencies under the Standardized Approach to credit risk, was criticised for directing lending away from developing countries with a poor credit record, as well as exacerbating bubble tendencies in emerging markets. The latter was based on the notion that rating agencies act in a procyclical manner, consistently giving high ratings to high performers, and thereby failing to acknowledge a looming crisis before it is too late. This perception was somewhat strengthened by the 1997 Asian crisis, where the ‘tiger economies’ continued to receive high ratings before suddenly collapsing. Related to this was a general fear of destabilisation of financial markets due to a perceived procyclical nature of ratings. This applied both to those ratings undertaken by external agencies, as well as those of the internal models utilized by the IRB approaches. Finally the banking industry expressed discontent with the methods for calculating capital requirements to match operational risk. (Wood 2005: 144).

The criticism of the ideas presented in the second consultative package was so intense that the Committee, in violation of its original plan, chose to issue a third package. This was issued for comments in July 2003, and contained several changes. As already mentioned, the Committee had submitted to German demands in the SME dispute. The draft furthermore encompassed several changes potentially beneficial to big banks. Initially, a 20% capital charge had been set as a floor for operational risk calculated after the AMA approach. This was now removed, potentially allowing banks employing this method to reduce capital even further. Similarly, the Committee softened its original stance on maintaining overall capital levels, stating that capital requirements

calculated through one of the IRB approaches might sink to 90 % of the present level within the first year after the accords implementation, and further down to 80% in the course of the second year. (Wood 2005: 137-147).

The more than 200 comments on the package, received from regulators, academics and interest groups, illustrated a continued high interest in the policy process. Particularly strongly commented upon was a proposition to calculate capital requirements for credit risk partially on the basis of expected losses, instead of unexpected losses only, which the Committee in a press release identified as a policy area with room for improvement. In addition, the Committee expressed intentions to simplify the treatment of asset securitization, to reconsider the treatment of credit card commitments, as well as to revisit the treatment of a selection of credit risk mitigation techniques. Referring to the comments received, as well as research undertaken by the Committee's working group, the Committee chose already in that press release to backtrack on its initial intentions to include expected losses in capital requirement calculations. (BIS 2003). In the course of the following six months, agreements were reached on the remaining issues as well. Thus, 11<sup>th</sup> May 2004, the Committee could issue a press release stating that consensus had been achieved, and that a final draft on Basel II was immanent (BIS 2004). This was to come 26<sup>th</sup> June 2004. Finally, in July 2006, a comprehensive version was issued. This incorporated the 2004 draft, together with a few other existing Basel Committee guidelines on capital adequacy, among those the parts of the 1988 accord which had not been revised during the policy process (Basel Committee on Banking Supervision 2006).



**Table 2: Basel II chronology of events**

<b>June 1998</b>	William J. McDonough appointed as new chairman of the Basel Committee
<b>September 1998</b>	Start of the policy process. <i>The Basel Committee’s Task Force on the Future of Capital Regulation</i> , led by Claes Norgren, begins a review of the accord.
<b>April 1999</b>	Intended deadline for the first consultative package. Extended due to internal disagreements
<b>June 1999</b>	First consultative package submitted
<b>January 2001</b>	Second consultative package submitted
<b>July 2003</b>	Third consultative package submitted
<b>June 2004</b>	Final document submitted
<b>July 2006</b>	Updated, comprehensive version of final document submitted

**1.5: Investigating the Basel II policy process: Method and Data**

The challenge of this thesis is to make a theoretically informed account of the policy process behind Basel II. Consequently, we need a strategy for investigating empirical evidence, suited to explain such a process. As has by now been thoroughly established in the case study literature, a useful approach to this type of investigation is the strat-

egy known as process tracing. Simply speaking, this strategy endeavours to identify the causal chain linking the dependent variable to one or more independent variables. (George and Bennet 2004: 206). It is thus based on close scrutiny of process, rather than on e.g. statistical comparison of various inputs and outcomes. A central challenge is to identify and eliminate alternative explanations, which might rival those of the hypotheses we are testing.

Ideally, such an analysis should be performed with full access to all relevant data. Only then, we could be certain to have eliminated any spurious connections, and be sure that the independent variable(s) identified indeed are the cause(s) of the dependent variable. However, such conditions rarely apply in the real world. This is not at least true when trying to investigate policymaking within an institution such as the Basel Committee. The accessible data which could shed light on the policy process is, at the best, patchy. Admittedly, the Committee has seen a significant improvement of transparency since the making of the first accord. Most notably, with the exception of those comments where secrecy was explicitly requested by the issuers, the comments received on the second and third consultative packages were published on the Committee's internet pages. However, there are no records of the debates taking place within the Committee, not to mention of the informal arguing and bargaining that might have taken place outside the official setting in Basel. Thus, we are forced to seek an insight through more indirect sources.

Consequently, the analysis to be performed in this thesis will draw on three main types of data. Firstly, interviews have been made: With the head of the Financial Supervisory Authority of Norway, Bjørn Skogstad Aamo, with former Basel Committee member and head of the Swedish Financial Supervisory Authority, Claes Norgren,<sup>17</sup> and with Alf Arne Hageler, director of the Norwegian Financial Services Association. (Skogstad Aamo 2007 [interview]; Norgren 2007 [interview]; Hageler 2007 [interview]). Secondly, the analysis has made use of a wide range of primary documents,

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<sup>17</sup> As chairman of the Basel Committee's Task Force on the Future of Capital Regulation, Mr Norgren led the work with developing the new framework from September 1998.

accessible through the web-pages of the Bank for International Settlements. These documents include the three consultative packages and the final draft of the accord, press releases and other documents issued by the Committee in the course of the process, as well as most of the comments received from external actors on the second and third consultative packages. Other relevant primary sources, such as speeches, have, when accessible, also been utilized. Thirdly, there is a body of existing academic literature on the Basel Committee. Although most of this literature is preoccupied with Basel I, or with the economic implications of Basel II, there are already some academic accounts of the Basel II policy process. Among the most substantial of these is Wood (2005). The insights from this literature will, where appropriate, be used in the analysis.

The abovementioned data sources are by no means ideal. Interview data are vulnerable to biases in personal interpretation of events, as well as lapses in memory; the latter is exacerbated by the almost ten years time span between the initiation of the revision, and the interviews. Furthermore, only one of the interviewees (i.e. Claes Norgren) was directly involved in the policy process. The other interviews do therefore in most cases count as assessments from (admittedly highly qualified) external observers, rather than as primary sources. The documents accessible from the Basel Committee are seldom direct descriptions of the events behind a decision. For purposes other than to find simple facts, such as at which point in time a specific provision was incorporated in the draft, these documents have their main use as proof of the policy actors' publicly expressed concerns and intentions. The existing literature on the Basel Committee offers access to interview data and document analyses complementary to those performed by the author of this thesis, albeit only through the interpretations of other researchers. These weaknesses of the data material are not possible to omit. They could, however, be mitigated through the analytical approaches chosen. One strategy for coping with patchy evidence is data triangulation, which indicates that each conclusion made is sought supported by multiple sources of evidence. What is essential, is that the different data sources lead to the same conclusion about the problem investigated. If this is the case, the validity of the conclusion made is strengthened (Yin 2003: 97). To

the extent that it is possible, this technique will be sought applied in this thesis. Before we embark on our analysis, we do however first need to clarify the theoretical framework towards which the policy process should be interpreted. This will be the issue in focus in chapter 2.

## 2.0: Three theoretical perspectives on policy change

As has been established in chapter 1, Basel II entails significant change. The challenge of this thesis is to explain this change's causes. For this purpose, three questions are asked. The first of these asks *why* the accord was changed, and thus concerns the motivation behind the revision. The second question asks *who*, and is thereby preoccupied with the identity of the actors involved in the policy process. The final question concerns the mode of the policy process, i.e. *how* the new regulations have been created.

I will employ three theoretical perspectives to answer these questions. The first of these, to be outlined in 2.1, is the theory of epistemic communities. This perspective will seek to explain the policy change of Basel II as a result of diffusion of knowledge in transnational networks of experts. The second perspective has its roots in comparative political economy and classic theories of international politics, and will here be called Varieties of Capitalism and International Political Economy (VoC/IPE) . This approach sees Basel II as a result of changes in the domestic financial and industrial structure of important member states, or of changed power relations in the international political economy. It will be elaborated on in part 2.2. The final perspective has been given the name transnational governance, and is the issue in focus in part 2.3. Rather than providing an alternative explanation to those predicted by the epistemic community and VoC/IPE perspectives, this approach seeks to promote a deeper understanding by investigating the influence of actors not accounted for by the two other perspectives. Consequently, it will focus on the influence of private actors from the financial industries, as well as the role of the EU. Applying the logic of each theoretical perspective, I will develop hypotheses related to the three questions why, who, and how. These hypotheses will later, in chapter 3, be tested against the evidence from the policy process of Basel II.

## 2.1: Epistemic Community

The theory of epistemic communities is the first of the explanatory concepts employed by this thesis. Within the realm of International relations (IR), the use of this concept is especially connected to a 1992 special issue of *International Organization*. In that journal, epistemic community is defined as ‘...a network of professionals with recognized expertise and competence in a particular domain and an authoritative claim to policy-relevant knowledge within that domain or issue-area’ (Haas 1992: 3). The members of these networks of experts are characterized by four features. Firstly, they share normative beliefs within the relevant issue area. This entails a high degree of internal consensus within the group, on which outcomes are desirable, and which are not. Secondly, they share a set of causal beliefs, which define how the members perceive the linkages between possible policy alternatives and desired outcomes. Thirdly, the epistemic community profess a shared notion of validity. Entailed by this is a shared set of intersubjective criteria for assessing the value and acceptability of various types of knowledge. Fourthly, they share a communal policy programme. This describes a shared set of practical responses to a particular problem, such as e.g. global warming or international financial stability. It is around this policy programme all activity of the epistemic community centres. Members are motivated by the desire to see the policy programme realised, not by the prospect of private material gains. Furthermore, the commitment of the individual member to the shared policy programme is strongly evidence based. If new knowledge should come up, which undermined the causal beliefs upon which the policy programme is based, the epistemic community would dissolve. Consequently, it would not try to find new arguments in favour of their policy programme, if new evidence suggests it is flawed. (Haas 1992: 16-20; Sebenius 1992: 323-326).

Importantly, it is the combination of these characteristics that makes a group an epistemic community, and distinguishes it from other policy relevant actors. Members of an epistemic community are united both by policy purpose, and by the shared method upon which their beliefs are founded. In contrast, an academic profession (such as

economists) might be united by shared causal beliefs and knowledge base, but lack shared normative beliefs and policy programme. They are consequently united by method, but not by purpose. On the other side of the spectre, interest groups (such as industry lobbyists or NGO's) centre their activity on shared normative beliefs. The members might, however, base these beliefs on differing experiences (i.e. knowledge bases), and might hold diverging perceptions of causality. They are therefore united by purpose, but not by method.

It is thus evident that epistemic communities constitute a distinct type of actors, different from other actors relevant to public policymaking. To understand their impact on policymaking, we must, however, also clarify through which mechanisms an epistemic community could exercise influence. To answer this question, we must appreciate how the underlying assumptions of the epistemic community approach differ from those of traditional approaches to international politics, most notably, from the realist and liberal institutionalist schools. The features distinguishing the epistemic community approach from these alternative understandings could be analysed along two dimensions.

The first of these concerns the identity of main actors. Both realism and liberal institutionalism are state-centric approaches, i.e. they view international politics as interaction between sovereign states. The epistemic community perspective is in contrast transnationalist.<sup>18</sup> International policymaking is perceived not only as interaction between states, but rather as cross-border interaction between a multitude of national, supranational and sub-national actors. As border-transcendent networks of experts, epistemic communities constellate one such group of actors, with a potential to influence policymaking.

The second dimension concerns the causes of policy change. Both realism and liberal internationalism tend to view the outcome of international-level policymaking as a function of the relative power of participating states, and of the costs and benefits ac-

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<sup>18</sup> Haas (1992: 17) also mentions the possibility of epistemic communities being confined to one single state. To be a vehicle of international policy coordination, an epistemic community does however necessarily have to transcend national borders. Thus, the term will in this thesis refer to transnational epistemic communities.

cruing to individual states from alternative policy options. Change is often understood as a result of external shocks, such as war or technological innovations. These might alter relative power-relations and pay-offs from different policies. As a consequence, they change the states' perceptions of which policies are desirable, and which are not. To employ the concepts outlined in the introduction, policy change is interest based. In the view of the epistemic community approach, policy is in contrast shaped by knowledge. It is normative and causal beliefs that matter, rather than power relations. The trigger of change is therefore new information. This information is diffused through transnational networks. Thereby, it could change normative and causal beliefs, and consequently create a momentum for policy change. In other words, policymaking is knowledge based (Haas 1992: 6; Holsti 1995).

Epistemic communities might, as we have seen, in theory contribute to policy change. The question of whether the concept has practical relevance for the policy process of Basel II, does however remain. If it has, we must necessarily be able to identify an epistemic community concerned with banking regulations. Hence, either one of the following two conditions must apply. Either, an epistemic community was behind Basel I, continued to exist thereafter, and at some point in time evolved to favour the mechanisms of Basel II over those of Basel I. Alternatively, if there was no such enduring presence, an epistemic community emerged at some point between the 1988 accord, and the initiation of the Basel II policy process.

Concerning the first alternative, i.e. the continuous presence of an epistemic community since the making of Basel I, there is not much support to be found. When considering the issue in one of his famous analyses of the Basel I process, Kapstein (1992: 266-268) found no evidence of epistemic community involvement. The national regulators represented in Basel, neither agreed on the necessity of capital requirements, nor had any shared understanding of how best to ensure global financial stability. Hence, they lacked both shared normative beliefs and a communal policy programme. Rather than being pushed through by an epistemic community, Kapstein therefore regarded the 1988 accord as caused by political manoeuvring by bureaucrats pursuing narrowly



defined national interests. As elaborated on in part 1.3, the choice of a common capital adequacy standard was the politically most palatable policy option, given diverging national interest. It was therefore not a reflection of any widely held idea that this specific policy was best suited to ensure a stable and efficient financial system. Basel I was in other words not a product of a policy programme embedded in transnationally shared causal and normative beliefs. Consequently, it was not brought by by an epistemic community.

However, Kapstein's article acknowledged the second alternative, i.e. the emergence of an epistemic community in the years following 1988, as realistic. In the early 1990's, when the article was written, two features were particularly conducive to such a development. The first was due to the Basel Committee itself. As a thoroughly established meeting ground for regulators, the Committee's sessions provided an opportunity to exchange information, and to build trust between regulators across national borders. The second was a product of technological change. Banking supervision did in the years following Basel I become increasingly technically sophisticated and codified. This facilitated the establishment of a shared methodological framework, and thereby, rational debate based on shared premises. Consequently, convergence of policy beliefs, and the potential emergence of a shared policy programme across national borders, became easier than what would have been the case if policy debates were conducted nationally, based on premises derived from different methodologies. (Kapstein 1992: 266-268).

Taking Kapstein's findings into account, it is evident that epistemic community influence on the policy process of Basel II is contingent on such a community's emergence in the years following the 1988 accord. Consequently, we need an answer to two questions. Firstly: Has an epistemic community emerged in the sphere of banking regulation, since the days of the Basel I policy process? Secondly: Has this epistemic community had an impact on Basel II? The answer to both questions is, I will argue, yes. An epistemic community of banking regulators emerged during the first part of the 1990's, as will be shown in chapter 3. This community's policy programme centred on

a strong belief in the benefits of risk sensitive capital requirements and interactive supervision. It was instrumental in triggering the revision of the Basel Accord, and carries a central responsibility for the final outcome of the policy process of Basel II.

The present thesis asks three questions about this policy process, i.e. why the Basel Accord was changed and got its new shape, which actors had an influence on this process, and which mode the policy process followed. From these questions, and the ideas of the epistemic community perspective, we could derive three hypotheses. To start with the why-question: An epistemic community explanation, which as argued requires the emergence of an epistemic community at some point after 1988, would suggest that this community was instrumental in triggering the revision, and that it had decisive influence on the final outcome of the policy process. Thus, the first hypothesis to be tested by this paper is:

**H1.1:** The Basel Accord was reformed because a reform-inclined epistemic community emerged in the years following 1988. This epistemic community had important influence on the final outcome of Basel II.

The second question asks which actors were involved. It is evident that if the epistemic community perspective should have any explanatory power, the experts constituting the epistemic community must have played a prominent role in the policy process. Thus, the second hypothesis is:

**H1.2:** The key actors of the policy process of Basel II were experts belonging to the epistemic community identified under hypothesis H1.1.

Finally, the theory of epistemic communities has implications for the mode of policy making, i.e. for the question of how actor influence was articulated. Even if the members of the epistemic community share a policy programme, they might still disagree internally over details within the framework of this programme. However, the way such disagreements are solved is essential for whether a policy process could be con-

sidered shaped by an epistemic community. As mentioned, the policy ideas of epistemic communities are strongly evidence based. Consequently, they are open to impact from the power of the better argument. To identify activity from an epistemic community in a policymaking process, we therefore need an understanding of the dynamics of the discourse among the actors involved. A useful concept in this respect is the distinction between arguing and bargaining. Arguing describes a speech act intended to persuade, i.e. to change the opponent's beliefs about factual and normative matters. Central to this concept is therefore persuasion through the power of the better argument. In other words, it is the validity of the argument that matters, not a negotiator's ability to inflict costs on unyielding opponents. Consequently, negotiators engaging in arguing can not make use of threats, side-payments or other power resources to make his arguments heard. Bargaining does in contrast imply acts of communication intended to force or induce an opponent to accept ones claims. When employing bargaining, the parties are thus free to utilize power resources external to the negotiation context. To threaten, or to offer side payments, is therefore perfectly possible. (Elster 1992: 15). Almost by definition, a debate within an epistemic community must be based on arguing. Policy preferences are as mentioned evidence based, founded in shared methodology, shared causal and normative ideas, and a belief in a communal policy programme. Within such a context, threats or side payments can not be employed. Instead, policy actors have to build arguments which correspond with some shared notion of validity. The final hypothesis to be derived from the epistemic community perspective is therefore:

**H1.3:** The mode of policymaking was marked by deliberation among experts, i.e. by arguing rather than by bargaining.

## **2.2: Varieties of Capitalism and International Political Economy**

The second perspective to be tested in this thesis is anchored in the theories referred to in part 2.1 as realism and liberal internationalism. The distinction between these two perspectives is of less importance for our analysis; it could however briefly be mentioned that while liberal internationalism is concerned with how states cooperate to reach the Pareto frontier, realism is preoccupied with how power relations between states determine the triumph of one point on the Pareto frontier over others (Krasner 1991: 337-342). Of importance is however the emphasis both perspectives put on states as unitary rational actors, in pursuit of national interests. Policy preferences of individual states, together with relative power relations between states, are thus the key variables determining the outcome of international negotiations.

The bargaining power of the negotiating parties is determined by two factors. The first is each country's BATNA. This term, which is an acronym for Best Alternative to a Negotiated Agreement, describes an actor's best outside option. As no country could be forced into an agreement, a country would rather withdraw from negotiations to pursue a unilateral path, than accept an agreement that makes it worse off than its BATNA. Hence, the BATNAs of each of the negotiating parties demarcate the area open to bargaining. (Fisher & Ury 1981:101-111). The other factor is each country's capacity to impose pressure on others. Although no country could be pressed beyond its BATNA, the area between the BATNAs of the individual parties is open to bargaining. A country's outcome from the negotiations does thus equal its BATNA plus a premium. The size of this premium is determined by the country's ability to exercise pressure towards its counterparties. In practical terms, this could be understood as its capacity to inflict costs on non-submitting opponents. An example of such cost-infliction were the implicit threats of closing US and UK markets to non-compliant countries, which as mentioned in part 1.3 were instrumental in shaping Basel I.

The theory perspective outlined above offers a strong and rigorous model for explaining political interaction at the international level. By merely focusing on power play between states, it does however fail to explain the origin of differing national prefer-

ences. Through its treatment of the state as a black box, the perspective thus misses important information about the domestic processes determining which policies a state will pursue at the international level. This concern is addressed by the so-called societal school of international relations. As being propagated among others by Milner (1992: 9) this perspective views domestic distributional consequences as the key determinant of a state's preferences in international negotiations. Rather than being perceived as unitary and rational, states are considered to be characterised by a game between various domestic political constellations and interest groups. A state's policy preferences could thus be seen as a sum of the preferences of different domestic groups, weighted by these groups' access to the domestic policy process. Understanding international policymaking does as a result of this not only require us to investigate the game between national preferences at the international level, but also to analyse the domestic structures being the cause of these national preferences.

However, pursuing such a strategy would soon require us to make some demarcations. Making a detailed account of all interests of every member state would result in extreme complexity, and is not likely to bring much clarity to the analysis. Not all countries are equally interesting; some are more influential than others, and some have interests being more prone to clash. Helpfully, both the existing literature, as well as a preliminary investigation of evidence from the Basel II policy process, gives us some indication on where to look, and what to look for. In terms of theory, Fioretos (2001) takes the societal school of international relations a step further by combining it with the so-called Varieties of Capitalism (VoC) approach of comparative political economy. This term denominates a multifaceted strain of literature, with deep historical roots in social science research. While encompassing considerable variation, and often articulating the dominant worries of its time (e.g. ability to restructure obsolete industries in the 1950's, effectiveness in combating inflation in the 1970's, and strategies for coping with globalisation in the 1990's), one concept is central to the whole tradition. This is the claim that capitalist nations differ in their institutional structures. Rather than employing simple distinctions between capitalist and non-capitalist countries, the tradition distinguishes between sub-groups within capitalism. Capitalist na-

tions differ in how they organize financial-, labour- and product markets, something which again has impact on their competitive advantages. (Hall & Soskice 2001).

The relevance of the VoC perspective for the analysis performed in this thesis is its implications for our understanding of the causes of national regulatory preferences. According to VoC, these are a function of the country's industrial and financial structure. By analysing these structures, the objective preferences of each of the Committee's member states could be identified. Through this structured approach to the institutional determinants of national preferences, the perspective helps us to narrow the focus of our analysis. More often than not, the tradition identifies Germany and the US as representatives of what we could call most different systems. In terms of financial markets, Germany is often considered an archetypical representative of so-called bank based systems (where a high proportion of enterprise finance is raised through bank lending), while the US is considered the typical representative of capital market based systems (where firms tend to raise funds directly in the capital market). (Levine 2002: 398). A preliminary investigation of the policy process of Basel II further supports the distinction between Germany and the US as a defining one. Two of the major bones of contentions in the policymaking process were the struggles between these two countries over risk weighting for commercial mortgages and SME finance. Not only do these controversies illustrate that there has been a conflict between Germany and the US, they show that this conflict has been connected to features considered by the comparative political economy literature to be a central distinction between the two systems. This includes the well-known reliance of the German *Mittelstand* (the small- and medium sized enterprise sector) on bank finance.

If we bring the theories of international relations together with the Varieties of Capitalism tradition, we get a model of international economic policy making which takes account both of how domestic economic structures create national preferences, and of how divergent national preferences interact at the international level. In doing so, we bridge the gap between negotiation analysis derived from the International Political Economy (IPE) tradition and the predictions of national preferences made by Varieties

of Capitalism. We could thus label the perspective Varieties of Capitalism and International Political Economy; VoC/IPE for short. This model could be applied to all of the three questions asked by this thesis. In respect of the why-question, the model predicts two alternative causes behind the decision to revise Basel II. Either, policy change was initiated because the financial structure, and thereby policy preferences, of powerful states had changed. Alternatively, power relations in the international economy changed through the period following Basel I, a development which enabled new countries to push through their national interest on the expense of formerly dominant countries. Hence, the first hypothesis to be derived from the VoC/IPE perspective is:

**H2.1:** The Basel Accord was reformed because of changes in the financial structure of important member states, or because of changed power relations between Committee member states.

The answer to the second question, i.e. which actors were involved, could be derived from the perspective's preoccupation with states. While the theory of epistemic communities views transnational expert groups as the drivers of international policy coordination, the VoC/IPE perspective is internationalist in the true meaning of the word. Implied by this, international policymaking is perceived as a matter of negotiations between states, or more correctly, between state representatives pursuing national interests. Admittedly, also the experts of the epistemic communities are likely to be state representatives, i.e. public officials from national regulatory agencies. Furthermore, these officials could be said to pursue a type of national interest, inasmuch as the policy programme of the epistemic community is perceived to be in the best interest of all nations, including the nation the individual member belongs to.

The role of the actors in these two perspectives does however differ. While the public officials of the VoC/IPE perspective first and foremost are representatives of their individual nations, the key allegiance of the epistemic community members is to the epistemic community, or more correctly, to the shared policy programme of this community. Furthermore, while the policy actors of the VoC/IPE perspective are con-

cerned with a narrowly defined conception of national interest, i.e. benefits that might accrue to their nation, but not to others, the members of the epistemic community promote policies that are perceived to be in the interest of all nations. In addition to these general assumptions about the identity of the actors, we could use the indications given by the VoC literature and the preliminary investigation of evidence to make an assumption about the national identity of the most important actors. As mentioned, the distinction between Germany and the US is likely to be central. The second hypothesis to be derived from the VoC/IPE perspective is therefore:

**H2.2:** Public officials pursuing national interests were the key actors of the policy process of Basel II. German and American regulators were the central adversaries.

Regarding the final question, i.e. the mode of the policy process, the VoC/IPE perspective is a mirror image of the epistemic community perspective. As a negotiation process between states pursuing their own narrowly defined national interests, the policy process is likely to be marked by bargaining. Thus, the final hypothesis to be derived from this theory perspective is:

**H2.3:** The policy process of Basel II was dominated by bargaining. The size of BATNA, and the capacity to inflict costs and/or offer compensations, determined the bargaining power of individual states.

### **2.3 Transnational governance**

When choosing a theoretical perspective for an empirical analysis, an analyst often faces a trade-off between analytical scope and analytical stringency. Both are important virtues. Stringency, in terms of clearly defined actors, a clearly defined sphere in which the actors operate, and a clear and homogenous rationale motivating actions, facilitates the deduction of clear, falsifiable hypotheses. The benefit of this is, *ceteris paribus*, hard to overestimate. Clarity of the premises on which an argument is founded gives transparent, verifiable research, a scientific ideal with which it is hard to dis-



agree. However, stringency more often than not comes at a cost. Inasmuch as reality is, and continues to be, astonishingly complex, stringency requires strict, and often grossly simplifying, assumptions. Consequently, stringency is a scientific ideal in eternal conflict with the concern for the analysis' scope. A broad scope reduces the risk of ignoring important aspects of reality, a significant danger when trying to simplify complex social phenomena for research purposes. It does, however, entail a risk of turning the investigation into a catch-all analysis ascribing equal importance to everything found. This quickly leads to blurred categories and unclear behavioural assumptions, and consequently endangers the transparency and verifiability of the analysis.

The analytical perspectives presented so far in this thesis have been biased towards stringency. According to the epistemic community perspective, policy is influenced by experts with a shared policy programme, who interact in transnational networks of experts, and who shapes policy through the mode of negotiation identified by Elster (1992) as arguing. The VoC/IPE approach does in contrast view policymaking as influenced by national representatives interacting in classic international negotiations (i.e. between states), who are pursuing national interests anchored in diverging national political economies, and who are shaping policy through bargaining according to their respective power resources and preferences. The hypotheses derived from these perspectives are rivalling, inasmuch as one individual policy decision can not be explained by both perspectives (the policy process as a whole might, though). It is, however, unavoidable that these perspectives ignore many actors that might possibly have been involved in policymaking. An example is the private actors so strongly emphasized in this thesis' introduction, which have not yet been accounted for by any of the perspectives.

I will therefore introduce a third and final theoretical perspective, to be named transnational governance. The term is borrowed from a 2006 book edited by Marie-Laure Djelic and Kerstin Sahlin-Andersson (Djelic & Sahlin-Andersson 2006). As defined in that book, transnational governance refers to a mode of policymaking characterized by the involvement of a wide range of actors, government as well as non-government.

Furthermore, regulations are seen as forged by governance networks transcending national borders, rather than by states alone. The scope of potential actors included in this concept is extremely broad, encompassing among others states, national and transnational interest groups, and epistemic communities. Actors might carry a multitude of motivations, and interact both in domestic, international, and transnational arenas. The theory is in this respect more an assumption of the environment of the policy process, rather than of the identity of actors, or of these actors' motivations.

While reducing the risk of overlooking important information, the catch-all nature of this perspective does however significantly decrease the stringency of the analysis. If the investigation should include all possible actors, and ascribe to them all possible types of motivations and modes of interaction, the analysis would most probably become far too broad and unclear to add any understanding at all. Thus, even within this perspective, we must make some assumptions about which actors and processes are worth looking at. In contrast to the two other theoretical perspectives, the transnational governance approach does not give many guidelines for this task. Rather than deducting hypotheses directly from theory, we must therefore first turn the analytical chain up-side-down, and induct from the empirical evidence to theory. Only then, we could hope to deduct researchable hypotheses founded in the transnational governance theory. Consequently, we should start our analysis with a face value investigation of the empirical evidence, to identify which groups are likely to have influenced the policy process.

A preliminary investigation of the evidence indicates that four groups have been particularly involved in the policy process of Basel II. The two first of these, an epistemic community of banking regulators, as well as government representatives pursuing national interests founded in diverging national economic structures, are already treated by the epistemic community and VoC/IPE perspectives, respectively. They will thus not be in focus under the transnational governance approach. The evidence does however reveal an active role of two more groups. The first of these are transnationally acting interest groups. As such groups share some characteristics with epistemic com-

munities, it is pivotal for the analysis to develop a thorough demarcation, before we could investigate their importance.

Transnational interest groups do, not surprisingly, share the transnational nature of epistemic communities, i.e. they act in networks transcending national borders. In their internal organisation, as well as in their motivation, the two categories are however distinct. As defined by Haas (1992: 18), an epistemic community requires shared causal beliefs among its members, as well as a communal knowledge base (including shared notions of validity) from which conclusions could be inferred. Furthermore, epistemic communities could by definition not be motivated by private material gains. Such conditions do not need to apply to a transnational interest group. In contrast they might be constellations of actors unified by shared normative beliefs (i.e. what should the policy look like), but not by shared causal beliefs and knowledge base. Furthermore, they are likely to be motivated by private material gains for their members, or at least for the groups their members claim to be concerned about. They are consequently focused on redistribution, rather than on improving the Pareto optimum.

When we investigate the actors involved in the making of Basel II, we find a substantial group of actors fitting into the transnational interest group category. Their importance is as mentioned in the introduction connected to the relatively open nature of the Basel II policy process. While the policymaking of Basel I was, as shown by among others Oatley and Nabors (1998), characterised by high level manoeuvring between top level regulators and politicians, the evidence from the policy process of Basel II gives a different impression. In the course of the process, the Committee issued three preliminary drafts for comments, an opportunity which was vigorously seized by a wide range of interested parties, including many (especially big) banks, and financial industry associations. Furthermore, the Committee occasionally invited financial industry actors to workshops; these workshops were especially focused on topics marked by high technical uncertainty, such as operational risk (Norgren 2007 [interview]). This extensive involvement of private actors represents something new in the history of the Committee. Certainly, interest groups are likely to have lobbied national regula-

tory agencies since time immemorial, and thereby influenced national preferences in international negotiations. Direct strategies towards, and active involvement in, the policy process at the global level (i.e. in the Basel Committee), is however a remarkable innovation. It is, nevertheless, consistent with the general trend in global economic policymaking, where the involvement of non-state actors such as private companies and NGOs has been on the rise since the early 1990's (Schuppert 2006). Making an effort to explain this aspect of the Basel II policy process is therefore highly justified, both by the empirical findings and by the general body of theoretical literature on global policymaking.

The second actor emerging as important when investigating the evidence is the EU. This aspect has so far largely been disregarded by the literature on the Basel Committee. In some of the interviews made for this thesis, the role of the EU was however strongly emphasized. (Skogstad Aamo 2007 [interview]; Norgren 2007 [interview]). Not only does the Basel Committee encompass nine EU member states, the EU Commission and the European Central Bank (ECB) are themselves represented in the Committee, albeit only with an observatory status. The role of the EU can therefore not be ignored, if a thorough investigation of Basel II should be developed.

What are the consequences of the involvement of these groups for the three questions asked by this thesis, i.e. why the accord was changed, which actors were involved, and which mode the policy process followed? The transnational governance perspective does not endeavour to rival the epistemic community and VoC/IPE approaches in pretending to give the one and only answer to these questions. Doing so would be highly implausible, inasmuch as the perspective centres on actors without formal decision-making authority in the Basel Committee. Clearly, it is unlikely that transnational interest groups and the EU should be the only actors with a say, faced with epistemic community members and national regulatory representatives with representation and vetoing rights in the Committee. The challenge is therefore more to identify whether or not transnational interest groups and the EU had an influence on the policy process, rather than championing the transnational governance approach as the only explana-

tion. Consequently, the theoretical perspective will be a complementary rather than a rivalling explanation of Basel II. Concerning the why-question, the task is thus to identify whether the outcome of the policy process was influenced by other actors than the experts of the epistemic community perspective and the national regulatory representatives of the VoC/IPE approach. Noteworthy, in the argument above, such potential actors were identified as being without formal decision-making power in the Basel Committee. For the hypothesis development, this could serve as a useful starting point.

The introduction of actors without formal decision-making powers raises an important question. This is the question of how such actors could influence the policy process. Clearly, this is a lot less obvious than what is the case with actors with formal decision-making powers. Broadly speaking, actors without formal decision-making powers could influence policymaking through two mechanisms. One is benign to the general interest, the other malignant. The first type concerns mere information seeking. Seeking advice from external actors (i.e. those without decision-making powers), increases the information accessible for decision makers. *Ceteris paribus*, this can only have a beneficial impact on society, inasmuch as decision makers are allowed to make more informed choices. Assessing the nature of the issues treated by the Basel Committee, there are good reasons for why the decision makers of the Committee should seek such external advice. Since Basel II to a large extent concerns the daily operation of banks, the banking industry is likely to possess important information about how best to achieve the dual goals of financial market stability and efficiency. Furthermore, involving banks in an early phase of the policymaking process is likely to ease implementation, as banks could give advice on the optimal pace of implementation, as well as being given longer time to prepare.

The other possible category of influence is in contrast much more problematic, and concerns the prospect of regulatory capture. This refers to the possibility that a regulatory agency (such as the Basel Committee) might become too close to the industry it is supposed to regulate, and thereby starts to identify the interest of society with whatever are the interest of the regulated industry. The causes of such capture could be

many, but extensive interaction between the regulator and the regulated, in combination with limited external control, is likely to increase the risk. Considering the mode of policymaking employed by the Basel Committee, Basel II seems to have followed a recipe for capture. The members of the Basel Committee were professionals from national regulatory agencies, the non-state actors involved in the workshops and comment rounds mostly represented the industry, and the interest in the reform process was with few exceptions insignificant among parliamentarians and the general public. Hence, it is evident that capture has been a realistic possibility connected to Basel II. Based on the transnational governance perspective, we could on the background of this derive a hypothesis about why the accord was changed. Noteworthy, this hypothesis does not endeavour to become the sole explanation of the why-question. Thus, it is focused merely on identifying influence. In addition to this overall hypothesis, we could develop two rivalling sub-hypotheses concerning the nature of this influence. Consequently, the first hypothesis to be developed from the transnational governance perspective reads as follows:

**H.3.1:** The decision to revise the Basel Accord, as well as the outcome of the policy process, was influenced by groups without decision-making powers in the Basel Committee. This influence took the shape either of:

- a) Contributions to inform the decision-making process, or
- b) Capture

The second question on which the transnational governance perspective will test its explanatory powers, concerns the identity of the actors involved in the policy process. The transnational governance perspective does, as already mentioned, emphasize two groups. One of these, the EU, is already relatively clearly identified. The category transnational interest groups could however be further refined, by inferring from the existing literature on interest groups in policymaking. A standard work within this tradition, Mancur Olson's *The Logic of Collective Action* (1965), argues that a group is more prone to engage in attempts to influence policymaking if the benefit accruing to each member of this group is large. As was argued in part 1.2, big banks have the most

to gain from the new accord, through its increased focus on advanced risk management techniques. Consequently, big banks and their interest organisations should be at the core of the analysis. The second hypothesis to be derived from the transnational governance perspective is therefore:

**H.3.2:** Big banks, financial industry groups, and the EU had important influence on the policy process.

For the final question asked by this paper, i.e. what mode the policy process followed, the transnational governance perspective implies a relatively open process. If a multitude of actors, private as well as public, should participate in the making of Basel II, there must have been channels enabling external actors (i.e. actors other than the official government representatives of the Basel Committee) to influence the process. Thus, rather than being confined to a narrow circle of public officials, the policy process of the Basel Committee must have reached out to society in some way. This has consequences for the mode of policymaking. Rather than arguing or bargaining among equals, which are the modes visualised by the theory of epistemic community and the VoC/IPE approaches respectively, a transnational governance mode of policymaking must have been marked by interaction between actors at different levels.

On the one hand, there have been internal actors, i.e. the national representatives of the Committee. These have been in charge of the process, deciding which policy alternatives to adopt, and which to reject. The internal actors have however interacted with a number of external actors, either through information seeking, or through agency capture. Thus, actors without formal powers in the Committee have been able to exercise influence. According to the transnational governance perspective, policymaking in the Basel Committee therefore took place in a network of multiple actors, internal to the Committee as well as external to it. Since the internal actors had vetoing and agenda setting rights, while the external had not, this network was asymmetric. Hence, the final hypothesis to be tested in this paper is:

**H.3.3:** Policymaking took place in open, multilevel and asymmetric networks.





### **3.0: Solving the puzzle: The policy process of Basel II**

Having outlined the context and consequences of Basel II, as well as having presented three theoretical perspectives on policy change, it is time to return to the core task of this thesis. This is, as has been repeatedly emphasized, to explain why the accord was changed, to identify which actors were involved, and to describe the mode of the policy process. The challenge is therefore to make a theoretically informed, historical account of the events taking place in and around the Basel Committee from the period immediately preceding the initiation of the revision process in 1998, to the submission of the final draft in 2004. As outlined in part 1.5, a process tracing strategy will be employed to achieve this target. Following this strategy, the policy process behind Basel II will be interpreted according to the three theoretical perspectives outlined in chapter 2; the outcome of these interpretations will then be compared against each other. The analysis is therefore organised as follows: Part 3.1 will analyse the evidence from the policy process through the epistemic community perspective. Similarly, part 3.2 and 3.4 will undertake analyses according to the VoC/IPE and transnational governance perspectives, respectively. Finally, part 3.4 will use the insights gained from these analyses to explain why the accord was changed, which actors were involved, as well as which mode the policy process followed.

#### **3.1: The policy process of Basel II – an epistemic community approach**

How could we investigate whether the theory of epistemic communities usefully explain policymaking in the Basel Committee? As outlined in part 2.1, this perspective's core argument is that policy change could be perceived as a matter of knowledge diffusion in networks of experts. Thus, we need to identify the presence of such a network in or around the Basel Committee at the time of the making of Basel II, as well as this network's influence on the policy process. Consistent with the logic of process tracing, which was elaborated on in part 1.5, Haas (1992: 34) outlines a relatively straightforward research strategy, which could usefully be applied to this analysis. The

strategy's first step is to identify the members of the relevant epistemic community, the normative and causal beliefs of these members, as well as the community's shared policy programme. Having successfully achieved this, the next step is to trace the community's activities, and thereby demonstrate its ability to exercise influence on decision makers. Accomplishing this is however only half the job. While the identification of the epistemic community and its ability to influence policymakers is a necessary starting point, the real challenge is to prove that the community in fact has had impact on final policy choices. Thus, the third step is to identify whether any credible alternative policy outcomes were foreclosed as a result of influence from the epistemic community, and whether there are alternative explanations for the actions of decision makers, which justifiably could rival the impact of the epistemic community as the core explanatory variable.

Applying the abovementioned strategy on Basel II, the first challenge to be solved is to identify the epistemic community, i.e. its policy programme, members, and causal and normative beliefs. A useful starting point in this respect is the policy programme, and the normative and causal beliefs in which this programme is embedded. If we know these, the epistemic community members could easier be identified. To start with the policy programme, it is far from obvious how this could be singled out for research purposes. Rather than an explicitly articulated policy agenda, it is likely to consist of a set of implicit ideas. An entry point to the understanding of this programme does however go through backward induction from the final outcome of the policy process. The logic behind is that if an epistemic community had success in influencing the policy process, the community's policy programme must necessarily be reflected in the final outcome.

Hence, the likely characteristics of the policy programme could be identified by drawing on part 1.2's analysis of the final draft. As was outlined there, Basel II is characterised by five features. These were: Increased sophistication and sensitivity of risk weighting, a move towards interactive governance involving both government and market actors, expansion of the number of tools employed in the governance process –

to include supervision and market mechanisms as well as regulation –, increased flexibility in the application of regulations, and finally, a change in the decision-making process, which has moved from being a realm of government agencies only, to incorporate government agencies as well as market actors. Being the core features of Basel II, the policy programme of a successful epistemic community must have incorporated these.

On the background of this policy programme, we could proceed to identify the epistemic community's normative and causal beliefs. These must necessarily reflect the policy programme identified. Thus, the policy choices entailed by the final draft must be put in connection with perceived causal links between the policies chosen (i.e. causal beliefs), and objectives kept in high regard by the members of the epistemic community (i.e. normative beliefs). The latter category could be identified relatively easily. Inasmuch as members of an epistemic community by definition can't be motivated by private gains, the normative beliefs of an epistemic community could only be connected to features beneficial to the global financial system as such. Consequently, the necessity to enhance stability (i.e. prevention of banking crises), and efficiency of financial intermediation, are in this context the most likely normative beliefs (see page 5 of the introduction for an elaboration on these beliefs).

Causal beliefs constitute the link between the measures employed as a part of a policy programme, and the objectives derived from normative beliefs. The members of the epistemic community must in other words believe the policies they pursue are conducive to the objectives they desire. Consequently, we need to identify the link between the increased risk sensitivity, interactivity of governance, and flexibility of regulation entailed by the shift from Basel I to Basel II, and the wish to facilitate the stability and efficiency of the global financial system. This link could be identified at two levels. The first is related to qualitative changes to the modus operandi of banks, which are conducive to the objectives of financial stability and efficient financial intermediation. Among such changes are improvements in risk management practices the most important. Broadly speaking, risk in banking could be dealt with through one out of two

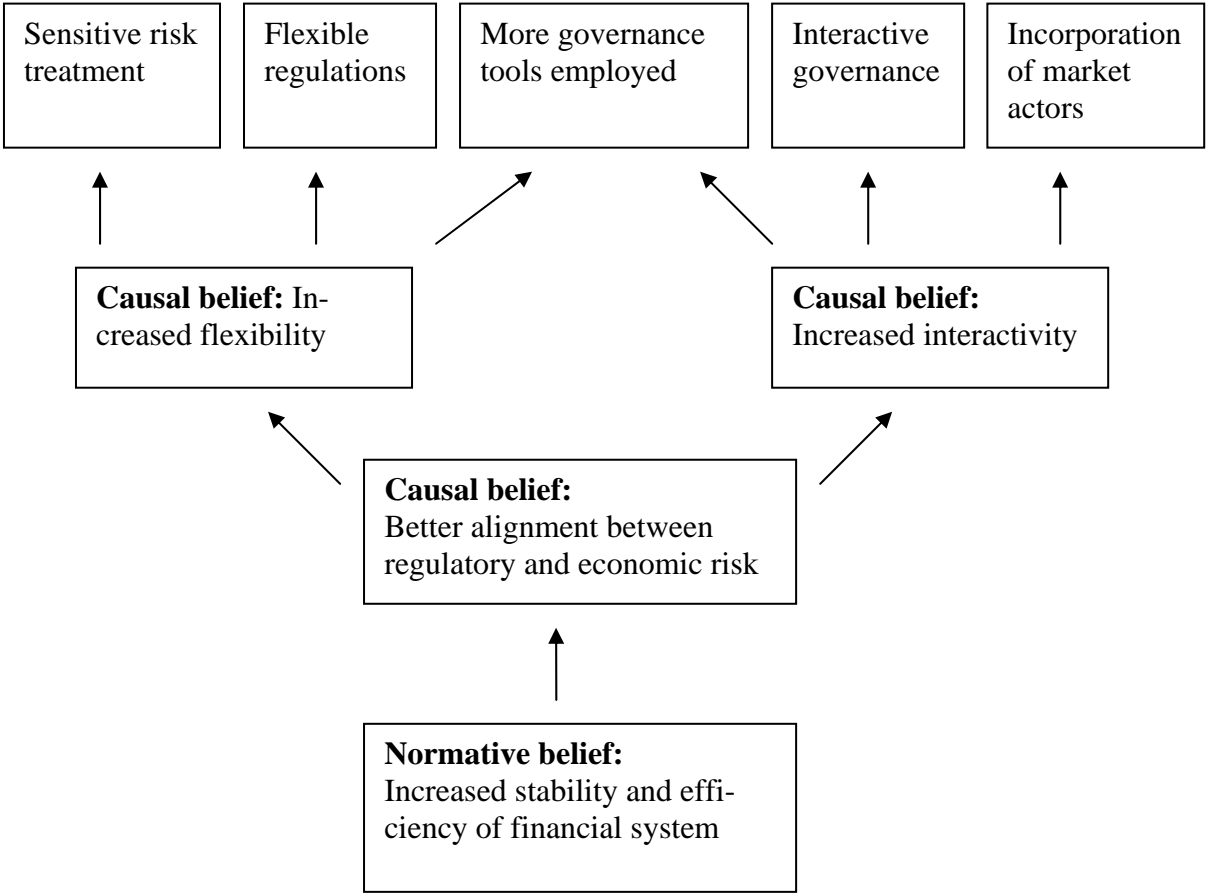
strategies. The first is to hold an undifferentiated, all-purpose cushion of capital, suited to absorb any losses, without making assessments of the likely sources of these losses. The other is to endeavour to estimate likely losses of individual assets, and thereby, to manage risk through techniques such as hedging.<sup>19</sup> (Merton 1995: 464). In practice, these two concepts form the extremes of a continuum, rather than a dichotomy. A risk-weighted capital requirement is thus an intermediate position between on the one hand an undifferentiated capital cushion, and, on the other, the theoretical position of having estimated, and hedged, all risk. Already Basel I entailed a move away from a pure, undifferentiated capital cushion, through its inclusion of (admittedly very crude) risk weights. However, through its much more fine scaled approach to risk rating, Basel II constitutes a major leap in the direction of a risk management based system. Consequently, it aligns capital requirements more closely to the underlying, measurable economic risk of a bank's assets. Having the normative beliefs outlined above in mind, there must therefore be a causal belief stating that more congruency between economic risk and regulatory capital requirements makes the financial system more stable, as well as more efficient in allocating capital.

The second level is related to practical policies believed to further these qualitative changes, i.e. to substantive changes to the governance regime. Among these changes, we find the aforementioned increase in interactivity and flexibility. Basel II entails increased flexibility in the application of risk management technology in banks, as well as a move towards an interactive mode of governance, where market actors are becoming more involved in the overall process of ensuring adequate capitalisation of banks. Thus, there must be a belief that this increased flexibility and interactivity will facilitate the development of sound risk management in banks. The causal beliefs of the epistemic community, as well as their connection to the policy programme behind Basel II, could consequently be illustrated as in table 3 on the next page.

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<sup>19</sup> Hedging refers to a variety of techniques of insurance against losses.

**Table 3: Likely policy beliefs of a Basel II epistemic community**



The paragraphs and the figure above identify the likely characteristics of an epistemic community related to the policy process of Basel II. To infer from this that such a community was present in the policy process, and had impact on the final outcome of the accord, would however be tautological. After all, its characteristics have been derived through an investigation of the final outcome. Thus, we need to investigate the evidence from the policy process, to find support for the actual presence of an epistemic community sharing the beliefs outlined above. To answer this question, we must at the very least identify the community’s members. A clear demarcation of such a group is difficult to establish; the interview data does however provide some guidelines. To quote Claes Norgren:

*‘...you could put it the way that we were technology optimists. We were convinced that modern financial theory and analysis could be used for practical purposes, to make risk estimations, and hence, to optimise capital’* <sup>20</sup>(Norgren 2007 [interview])

This could be interpreted as a policy programme. We could identify a normative idea (i.e. to optimise capital, which would mean to make the international financial system as stable and efficient as possible), as well as causal beliefs (i.e. the belief that modern financial theory allows better risk management, and hence, a move towards a more risk sensitive capital adequacy regime). In the press release issued in relation to the first consultative paper, Mr Norgren expressed similar ideas, stating that ‘the financial marketplace has developed dramatically during the past ten years’, and that the framework suggested in the paper therefore had been designed to ‘better align regulatory capital requirements to underlying risk, and to recognise the improvements in risk measurement and control’ (BIS 1999).

Noteworthy, the beliefs expressed through these statements are consistent with the ones outlined earlier in this chapter, as derived from the final accord. It is evident that Mr Norgren himself shared these policy ideas. But who else did? Another set of remarks from Mr Norgren strongly indicates that at least the Committee’s chairman between 1998 and 2003, William J. McDonough, did as well. In the words of Mr Norgren:

*‘...the work [with the revision] got momentum when McDonough became chairman... He had a vision, an idea, which was congruent with my thoughts and ideas...’* (Norgren 2007 [interview])

The perception that Mr McDonough held views similar to those professed by Mr Norgren, is supported by a selection of public statements made by Mr McDonough himself in the course of the policy process. In a speech held in September 2000, he emphasized

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<sup>20</sup> All quotes transcribed and translated from Swedish by the author.

the shortcomings of the 1988 accord, pointing both to its perverse incentive structure, and its increasingly outmoded nature. On this background, he encouraged supervisors to ‘develop a more dynamic, risk-focused and process-oriented framework’. (McDonough 2000). Similar views were articulated in a 2001 speech to the XIII International Frankfurt Banking Evening. In that speech, particular emphasis was put on the need for regulation and supervision to be risk sensitive, flexible, and adaptive towards the continuous process of innovation going on in the financial industries. (McDonough 2001). The same views were upheld in a 2003 address made to the Bond Market Association. In an explanation of the changes suggested by the Basel Committee, Mr McDonough again pointed to the crude nature of the old framework, to the technological evolution having taken place throughout the 1990’s, and to the need for a flexible and risk sensitive system of regulation and supervision. (McDonough 2003).

Another central policy actor professing beliefs similar to those of Mr Norgren and Mr McDonough was Alan Greenspan, then chairman of the Federal Reserve System.<sup>21</sup> In a 1998 essay, Dr Greenspan stated his support for a bundle of common criticisms against the existing Basel Accord. These included the arbitrary nature of risk buckets, the narrow selection of risk types accounted for by the accord, and the accord’s ignorance towards advances in risk management techniques. (Greenspan 1998: 164-165). Similar ideas permeated the Committee’s first consultative paper, which was published in June 1999, and thus is a further source of information of the beliefs dominant at the time. In its introduction, this paper argued that the financial world had gone through major developments in the course of the preceding decade. Consequently, capital requirements calculated according to the 1988 accord were no longer deemed an adequate regulatory tool. Especially the perverse incentives given by the possibility of regulatory capital arbitrage (see part 1.2), as well as the lack of incentives to employ risk mitigation techniques, were highlighted. (Basel Committee on Banking Supervision 1999: 8-11). Thus, the belief that the financial system needed a more risk sensitive regulatory framework, and the belief that an increase in flexibility and interactiv-

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<sup>21</sup> The Federal Reserve System (or the Board of Governors of the Federal reserve system, which is its full name) is one of altogether five regulatory agencies representing the US in the Basel Committee.

ity was the correct way to go, seemed to have taken hold of the Committee at this early stage of the policy process.

In addition to this evidence of the beliefs of actors within the Committee, there are certain indications of these beliefs extending beyond the confines of the regulators of the Basel Committee, to be shared by among others many industry actors. Especially the more sophisticated banks were by the early 1990's growing increasingly dissatisfied with Basel I, as illustrated by the lament of a bank manager quoted by *The Economist*: 'The guys that were supposed to protect the world banking system have caused banks to take greater risks' (Economist 1999a). Not only did the accord from the very beginning give perverse incentives, due to its crude risk weighting. As a result of massive technological developments in the early 1990's, risk management techniques and information technology soon allowed for remarkably different strategies for coping with risk, than what was allowed under Basel I. In the eyes of the banks, these techniques were better. To quote one contemporary observer of the financial industry: 'Big banks, which like to dissect risk with a scalpel, see the Basle standards as rusty broadswords' (Economist 1993: 30). Consequently, some of the most sophisticated banks eventually came to run parallel calculations of capital: One according to their own sophisticated techniques, another according to the rules of the Basel Accord. It thus hardly comes as a surprise that many industry actors started to favour a replacement of the existing accord with something more risk sensitive. (Ibid; Hageler 2007 [interview]).

The importance of this evolution of ideas within the industry becomes apparent when we investigate the background of the beliefs held by actors within the Committee. Although the evidence is limited, there are some features indicating that these beliefs originated from direct contacts with the industry. Before entering the Committee, Mr McDonough had for more than 20 years been employed by the First National Bank of Chicago, and had thus substantial personal experience with day-to-day banking activity (Merrill Lynch 2007). According to a statement made in a 2001 speech, this experi-



ence had been instrumental in shaping his belief in risk management as a tool to facilitate financial stability. In his own words:

*'As a former commercial banker, I know that...a well-trained staff and a robust system of risk management...make up the first line of defense against financial instability within an economy.'* (McDonough 2001: 1)

Mr Norgren emphasized this personal experience as a key difference between Mr McDonough and his predecessor Tommaso Padoa-Schioppa:<sup>22</sup>

*'[Mr McDonough] was a banker, a man who had grown up in a modern financial environment... [He] had worked for several big American banks, and understood the business in a new way... He had a conviction, which was a result of his background and experiences...'* (Norgren 2007 [interview])

Mr McDonough's entry was thus representative of an increased awareness in the Committee of the banking industry's negative experiences with Basel I. Mr Norgren himself did admittedly not have the same hands-on experience from the industry as Mr McDonough. He did, however, strongly emphasize his own personal experience, as a regulator overseeing the collapse of the Gota Bank in 1993. In his own words, the Basel I rules' failure to give an early warning about this bank's true condition, convinced him of the shortcomings of the existing framework, and of the need to move towards a closer alignment of regulatory capital and real economic risk. (Norgren 2007 [interview]). The momentum for policy reform in the Basel Committee was consequently symptomatic of a convergence of beliefs between industry and regulators. This convergence was brought by by new knowledge resulting from close observation of the effects of the existing Basel standards on banks. However, we should not interpret this as a capitulation of the regulators towards the banks. In Mr Norgren's words, the Committee was on a 'missionary expedition' (Norgren 2007 [interview]). In the case

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<sup>22</sup> Dr Padoa-Schioppa resigned from the Committee chair in 1997. Mr McDonough took over in June 1998, after a short intermezzo with Dutch central banker Tom de Swaan.

of issues still marked by high uncertainty and insufficient methodologies, such as e.g. operational risk, significant effort was dedicated to increase the understanding of the issue area, and to develop improved methodologies. Concerning credit risk, where many banks already had sophisticated methodologies in place, the effort was directed towards ensuring that all banks adopted such. (Ibid). As confirmed by Mr Hageler of the Norwegian Financial Services Association, Basel II does therefore entail an increased responsibility of the individual bank to prove towards the regulators that its risk management competencies are appropriate. (Hageler 2007 [interview]). Thus, the evidence supports that the Committee took a proactive stance, seeking to lead the industry, rather than reactively adopting changes desired by industry actors.

Further support for beliefs congruent with the policy programme outlined earlier in this part of the thesis, came from financial academics, as well as from parts of the financial press. In its 1993 banking survey, *The Economist* pointed to how advances in risk management techniques appeared to have fundamentally changed the way banks managed their portfolios. Consequently, the newspaper concluded, the regulatory framework would have to adapt. (Economist 1993). Also a 1995 special issue of *Journal of Banking and Finance*, in its entirety devoted to the question of bank capital, articulated the idea that a fundamental change in the craft of banking had taken place. Although not directly addressing the question of the viability of the Basel Accord, several contributions to this issue investigated the relationship between risk management and capital. (Berger et. al. 1995). Most prominently, Merton (1995: 463-467) argued that regulators had to change their practice, to incorporate recent advances in risk management technology. A more direct analysis of the problems of the Basel Accord was undertaken by Jones (2000). That article investigated the various techniques employed to achieve regulatory capital arbitrage, and concluded that the proliferation of these practices highlighted ‘the importance of seeking ways to more closely align regulatory measures of risk with a bank’s true economic risks’ (Jones 2000: 51).

It is therefore evident, that those of the Committee members who favoured a move towards greater risk sensitivity, could support their ideas on an increasing body of

widely held ideas. As Mr Norgren said about the background of the belief that risk management could be successfully employed to optimize capital: ‘We had knowledge of the research, we knew what leading banks did, and we knew what could be done by these banks’ (Norgren 2007: [interview]). There are in other words strong indications of there being a group of bankers, regulators, and academics with similar views on the need for, and the favoured direction of, a revision of Basel I. This being a transnational group of experts, with a shared policy programme, we could interpret it as proof of an epistemic community interested in a revision of the Basel Accord. The policy programme of this epistemic community is fairly consistent with the ideas outlined in table 3, and could best be summarised as being based on the belief that risk management could be used to optimise regulatory capital requirements (i.e. bringing them in line with underlying economic risk). Consequently, we have successfully taken the first step of Haas’ research strategy, which entailed identifying the members, beliefs, and policy programme of the epistemic community.

The next step of Haas’ strategy is to analyse whether this epistemic community had real influence on the policy process of Basel II, by tracing the activity of the community’s members, and thereby identifying their impact on the policy process. The key to this is to identify the epistemic community’s channels of influence. As argued above, members of the epistemic community were represented in central positions of the Committee. Thus, it seems clear that there has been significant opportunity for direct influence from the epistemic community on Committee policy. Furthermore, the ideas professed by this community are articulated in the final version of the new accord. It does however remain to identify the direct link between epistemic community presence, and outcome in terms of policy. A useful approach to this is to investigate the Committee’s mode of policymaking. As outlined in part 2.1, the link between an epistemic community and policy goes through arguing rather than bargaining. Presence of arguing in the Committee’s debates would thus support the notion of epistemic community influence.

The detailed mode of the policy debate in the Committee is hard to reconstruct, inasmuch as no detailed accounts are accessible. When analysing the available evidence, three features nevertheless indicate a prominent role of arguing. The first concerns the decision-making competencies of the negotiators. The representatives of the Committee were mostly top-level staff of central banks and national regulatory agencies. Resultantly, debaters were to a greater extent allowed to make independent decisions, than what would have been the case with lower rank staff. The debates did therefore, at least partially, take the shape of a round table conference, i.e. as a sort of open conversation among peers. This is well illustrated by a remark made by Mr Norgren on the mode of the debates: ‘No one presented orders from their superiors’ (Norgren 2007 [interview]).

The second feature is related to the degree of external scrutiny. Although the Committee has become significantly more transparent in the course of the last couple of decades, its internal deliberations are not public. Furthermore, while public interest admittedly is on the rise, the Committee is far from being subject to regular day-to-day interest from national politicians (Underhill 2005). As argued by Elster (1992: 46), publicity could push a negotiation towards a bargaining rather than an arguing mode. When public interest is high, and the constituencies of the negotiators are clearly demarcated (as necessarily is the case with national representatives such as those represented in the Basel Committee), it is likely that the leeway for negotiators to withdraw from initial positions is less, due to potential negative reactions from the domestic constituency. Partially, this could be used strategically by individual negotiators, as a commitment device. This indicates that a negotiator could act as if his hands were tied, and thereby, give the opponents the choice between full compliance and discord. However, even in the absence of such strategic use, mandates under conditions of extensive scrutiny from domestic constituencies are likely to become more strictly specified and inflexible. Consequently, negotiators become more prone to act as agents ‘presenting orders’ on respective national positions, rather than as individual experts trying to reach a shared understanding of best practice.

The third and final feature concerns the relatively high degree of uncertainty characterising some of the issues treated by the Basel Committee. A core part of the Committee's activity was to advance the understanding of topics about which very little commonly recognised knowledge existed. (Norgren 2007 [interview]). Keeping a clear, inflexible position on an issue is difficult when causal effects and potential consequences are unclear. Consequently, it is likely that negotiators were forced to engage in arguing to advance their understanding.

Interestingly, we could connect these observations to a theoretical point made by Kapstein (1992: 268). In his view, the development of an epistemic community among bank regulators would require insulation of international policy makers from domestic political pressures. Kapstein suggested the establishment of a supranational regulatory agency as a necessary precondition to achieve this. Such an agency has not been realised. However, through its inclusion of high-level policymakers, the relative absence of public scrutiny, and the very nature of some of the topics it deals with, it nevertheless seems like the Committee has managed to create a degree of insulation which enables its members to pursue a more open debate, than what would otherwise be possible in an international negotiation. Resultantly, there is more room for arguing instead of bargaining, an observation which strengthens the perception of epistemic community influence on the policy process.

The two final steps of Haas' research strategy are to identify whether any alternative credible policy outcomes were foreclosed due to the influence of the epistemic community, and whether there are any alternative explanations for the final outcome of the policy process. The latter point could best be investigated by outlining such alternative explanations, and testing their merit against the epistemic community explanation. Thus, it will be treated in part 3.2 and 3.3, where the VoC/IPE and the transnational governance approaches will be investigated, and in part 3.4, where the three perspectives will be compared against each other. The former point, i.e. foreclosure of alternative outcomes, could in contrast be treated here. In this respect, at least one alternative policy path could be imagined: The maintenance of status quo. Although minor

changes to the accord were made in the years following 1988, it was not given that the Committee in 1998 should embark upon a full-scale revision. According to Mr Norgren, this decision had much to do with the entry of Mr McDonough, and thus, with the strengthening of the epistemic community in the Basel Committee. In his own words:

*'We had had the feeling that the time was in for doing something [with the Basel Accord], but that things started to happen had much to do with Mr McDonough. He was a highly executive person.'* (Norgren 2007 [interview])

Thus, it seems perfectly possible that in the absence of an epistemic community advocating change, the Committee could have gone on for quite a while longer without initiating any revision.

Alternatively, we could have experienced a breakdown of the regime altogether. The main reason behind Basel I was, as argued by Kapstein (1991), US worries over the effect of domestic capital requirements on the competitiveness of American banks. If a main actor, such as the US, should come to the conclusion that it would be better off without the regime than with it, the already flaw-riddled Basel Accord is unlikely to have survived. Mr Norgren considered this to be a not unlikely scenario in the absence of a revision. (Norgren 2007 [interview]). Hence, we could argue that at least two alternative policy paths were foreclosed as a result of the activity of the epistemic community, i.e. either continued reliance on status quo, or an altogether break down of the regime.

Following the strategy outlined by Haas (1992) it has been made arguments supporting the existence of an epistemic community. This community centred on a policy programme favouring increased risk sensitivity and interactivity of regulation. It has furthermore been argued that the epistemic community involved key members of the Committee, and that it had an impact on the policy process and -outcome. Of Haas' list, it does however yet remain to test this argument against alternative credible expla-

nations. This will be the challenge of the three following parts of this chapter. Part 3.2 and 3.3 will interpret the Basel II policy process according to the VoC/IPE and the transnational governance perspectives, respectively. Finally, part 3.4 will consider the three perspectives against each other.

### **3.2: Basel II and Varieties of Capitalism/International Political Economy**

Researching the Basel II policy process through the VoC/IPE perspective requires a two-step strategy. Firstly, we must identify the policy preferences of the different member states, and connect these to national economic and institutional structures. Secondly, we must trace the policy process at the international level, to clarify whether the member states have pursued a strategy of bargaining to promote their respective national interests. For both analytical steps, it is useful to distinguish between two distinctive phases of the policy process: The initiation phase (i.e. before September 1998), and the policymaking phase (i.e. between September 1998 and the submission of the final draft).

Concerning the identification of policy preferences, theory as well as a preliminary investigation of evidence does as outlined in 2.2 urge us to focus on the conflict line between the US and Germany. Already in the initiation phase, this conflict line was present, albeit less articulated than what was later to follow. The need to target the problem of regulatory capital arbitrage caused by securitization was most strongly felt by the US, where this financial practice rose to prominence in the course of the 1990's. This was much less the case in Germany. German banks did still in the late 1990's predominantly engage in traditional lending. Thus, German regulators were less concerned about the workings of the existing accord, and were consequently less eager to embark on a long and painstaking revision process. (Kothari 2006: 112; Norgren 2007 [interview]).

This divergence of preferences was however to fade, compared to the clashes breaking out in the policymaking phase. At an early stage, conflict erupted over the intention to include external credit ratings in the Standardized Approach to credit risk. As outlined in part 1.4, the European member states, led by Germany, opposed such inclusion. This resistance was much due to the fact that rated companies were disproportionately concentrated in the US. (Economist 1999b; Wood 2005: 129). A further issue rose when the Americans wanted an end to the German practice of ascribing a favourable risk weight to Pfandbriefe. This practice, which had evolved under the Basel I rules, was of considerable importance to German banks, due to the massive size of the Pfandbriefe market.<sup>23</sup> Consequently, the Germans wanted to keep this special provision. (Economist 1999c).

The really severe conflicts, threatening to derail the whole policy process, were however to break out over commercial mortgages, and later, over the proposed revision of the rules for lending to SME's. As outlined in part 1.4, German regulators viewed the upkeep of favourable risk weightings for commercial mortgages as essential for their country's banks. Particularly the Americans did in contrast view this as economically unfounded and potentially dangerous to financial stability. (Economist 1999d; Norgren 2007 [interview]). The controversy over loans to SMEs was in many ways a related issue, which was raised after the second consultative package. Under the old accord, with its crude risk weighting, banks were implicitly allowed to cross-subsidise loans to this type of enterprises. The more fine scaled risk weighting of Basel II would however put an end to this opportunity. In the absence of any special provisions for such lending, many SMEs (i.e. the more risk prone ones) would thus find it increasingly difficult to obtain finance at an affordable rate. (Laslett 2002: 43). American regulators saw no reasons for treating SME loans different from ordinary private sector lending. In contrast, the Europeans in general, and the Germans in particular, vociferously argued in favour of such preferential treatment, pointing both to a perceived lower risk

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<sup>23</sup> The German Pfandbriefe market is estimated to be the world's seventh largest bond market, with a total value of about \$1 trillion. (Kothari 2006: 120).



of such assets, and more importantly, to the importance of adequate SME finance to their national economies. (Wood 2005: 138).

With the major inter-country conflict lines thoroughly identified, we could proceed to clarify how these conflicts influenced the policy process, as well as how they finally were solved. The initiation phase was, as mentioned, initially marked by German ambiguity towards whether a costly revision process really was necessary. Securitization was still in the mid 1990's a near absent phenomenon in Germany. Furthermore, the Continental European regulatory tradition was more sceptical towards risk sensitive capital requirements, than the Anglo-American one. Despite this initial reluctance, Germany did eventually develop to become a major proponent of a new accord. The reason behind this was according to Mr Norgren a fear that the US would implement unilateral changes, unless the international framework embedded in the Basel Accord was changed. As a middle-sized actor in international finance, the Germans ascribed a high intrinsic value to the per se presence of an international capital requirements regime. Hence, they would rather embark on a policy reform inspired by ideas they did not really share, than risk seeing the Americans going their own way, inasmuch as the latter would likely have led to the demise of the whole regime. (Norgren 2007 [interview]). The latent power of the US to bring down the regime could thus be seen as having disciplined the Germans into concurring to the revision.

This game between important Committee members was to continue in the policy making phase. The question of external ratings, for a start, found its solution relatively quickly. As mentioned, the major resistance against this provision was based on its potentially adverse consequences for banks with many unrated assets (i.e. the majority of banks outside the US). Hence, when the benefit the draft provided for banks with many rated assets over those with few, turned out to be ambiguous, European scepticism was to a large extent addressed. Since only the very top quality echelons of assets (i.e. those rated A- or better) were prescribed a better risk weighting than unrated assets (i.e.100%), the potential competitive advantage of (American) banks with a high proportion of rated assets became significantly reduced, if not entirely removed. Later

debates on this issue were mostly connected to worries over whether the positive treatment of unrated assets went too far, and that companies thereby were given too few incentives to get rated. Similarly, sentiments in Europe were calmed by the inclusion of the IRB approach, inasmuch as this did not entail the same possibility for a competitive advantage of American banks over its European competitors.<sup>24</sup> (Norgren 2007 [interview]; Wood 2005: 129-147).

The second issue of contention was, as mentioned, the ability of German banks to raise cheap capital through favourably weighted Pfandbriefe. American, British and Italian authorities wanted to prohibit the practice, while France and Spain, in contrast, contemplated introducing their own national equivalents of this financial instrument. (Wood 2005: 130). The final draft of Basel II did not single out Pfandbriefe as a separate category; hence, they were to be weighted according to the risk weight ascribed to the bank issuing them. However, the EU Commission's guidelines on implementation of Basel II in the European Union, which were developed in parallel with the accord itself, nevertheless allowed for continued favourable risk weighting of this asset class. (Deutsche Bundesbank 2004: 98).

A solution to the rows over commercial mortgages and effects of Basel II on the financing of SMEs, proved harder to reach. The former issue, commercial mortgages, caused a two-months delay of the first consultative package. (Wood 2005: 130). When the package was finally submitted, it did at the first glance of the eye still look like the Germans had lost the battle, inasmuch as the draft stated that 'mortgages on commercial real estate do not, *in principle*, justify other than a 100% weighting of the loans secured' (Basel Committee on Banking Supervision 2006: 24 [emphasis added]). However, in a footnote, the draft included a provision which could be interpreted as a concession to the German desire to continue ascribing a favourable weight to commercial mortgages:

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<sup>24</sup> Although IRB was put on the agenda due to resistance towards external ratings, it was less of a political concession than the other elements of the accord treated in this part of the thesis. Through aligning capital requirements better with underlying economic risk, it was wholly consistent with the policy programme of the epistemic community identified in part 3.1. In the words of Mr Norgren, it 'was a significant improvement of the accord' (Norgren 2007 [interview]).

*'The Committee, however, recognizes that, in exceptional circumstances for well-developed and long-established markets, mortgages on office and/or multi-purposes commercial premises and/or multi tenanted commercial premises may have the potential to receive a preferential risk weight of 50% for the tranche of the loan that does not exceed the lower 50% of the market value or 60% of the mortgage lending value of the property securing the loan.'* (Basel Committee on Banking Supervision 2006: 24 [emphasis added]).

Mr Norgren admitted this to be a pure political compromise, a concession given to bring the work on a more risk-sensitive capital adequacy framework further (Norgren 2007 [interview]).

The effect of Basel II on the financing of SMEs proved to become an even more contentious topic. Arising in the comment round following the second consultative package, this issue did for a while threaten to derail the entire revision process. Again, it was the Europeans, and especially the Germans, that worried the most. Among the comments submitted, industry actors, such as the German chambers of industry and commerce, and the (German) Association of guarantee banks, both emphasized the proposal's potentially adverse impact on the German SME-sector (the Mittelstand). As German SMEs already for quite some time had seen their access to finance dwindle, it was feared that further disincentives towards lending to firms in this sector would have severe effects for growth and jobs in Germany (Deutscher Industrie- und Handelstag 2001; Verband der Bürgerschaftsbanken 2001; Laslett 2002: 45). When the Committee initially did not show any intentions to yield to the demands for a better treatment of SMEs, German chancellor Gerhard Schröder publicly announced that he would oppose any future EU legislation based on the Basel Committee propositions. (Wood 2005: 141).

Facing the prospect of having the new accord blocked by one of the major member states, the Committee responded rapidly. In a July 2002 press release, it stated its in-

tention to include provisions for a more favourable treatment of SMEs in the accord. This provision was, in a slightly more technically sophisticated manner, kept in the final version of Basel II (BIS 2002; Basel Committee on Banking Supervision 2006: 64). It is evident that this retreat on behalf of the Committee was instrumental in bringing the policy process out of its deadlock. In a press release issued the same day as the one from the Basel Committee, the BaFin (the German regulator) celebrated the concessions as a major breakthrough for Basel II, and announced that worries for the effect of the accord on SME finance could now be put aside (BaFin 2002).

It is noteworthy that the by far most controversial topics, i.e. commercial mortgages and SME finance, were both intimately connected to differences in the member states' industrial and financial structure. Of particular importance was the unique relationship between German banks and small- and medium sized enterprises. This is based on long-term lending contracts and close relationships, and enables a high proportion of investments to be financed through bank loans. As observed by Mr Norgren: 'The Americans did at least learn one German word: Der Mittelstand' (Norgren 2007 [interview]). Hence, the evidence from the Basel II policy process strengthens the claim that national preferences are derived from domestic economic structures. Furthermore, both the indications of the Germans having been spurred into supporting a revision of Basel II out of fear of American unilateralism, and the explicit threats of blocking the accord over the question of SME finance, supports the claim that states have pursued their international interests through bargaining, i.e. through calling on external resources to impose cost on non-compliant negotiating parties. Thus, the key claims of the VoC/IPE perspective are supported.

### **3.3: Basel II in the perspective of transnational governance**

The final perspective, through which the Basel II policy process could be investigated, is that of transnational governance. As was the case with the other theoretical perspectives, the analysis will follow a process tracing approach. Thus, we must identify ac-

tors, trace the activities of these actors, and demonstrate their impact on the policy process. As was outlined in part 2.3, the transnational governance perspective centres on two categories of actors. These are, respectively, transnationally acting interest groups, and the EU. In the case of transnationally acting interest groups, influence on the policy process was predicted to go through the comment rounds following the three consultative packages, and through the workshops arranged by the Committee. In the case of the EU, the significant overlap between EU and Basel Committee membership, as well as the observatory role of the EU Commission and of the European Central Bank (ECB) in the Basel Committee, was highlighted as potential channels of influence. These are however still only assumption based on a superficial investigation of evidence, as well as on theoretical deductions. They thus need to be tested more thoroughly towards the empirical evidence. Consequently, we must identify the activities of transnationally acting interest groups, as well as those of the EU, in the Basel II policy process. Furthermore, we must find support for the assumption that these actors actually had impact on the outcome of Basel II.

In the case of transnationally acting interest groups, big banks and organisations representing them were singled out as the most likely groups to have been involved. As was accounted for in part 3.1, many big banks did through the 1990's increasingly see a discrepancy between the possibilities given by technological innovations, and the prescriptions of the Basel Accord (Economist 1993: 30; Hageler 2007 [interview]). Thus, as accounted for by Wood (2005: 126), many banks started to propagate the benefits of using the banks' own risk assessments as a basis for the calculation of capital requirements. The impact of this on the decision to start revising the 1988 accord is hard to assess, and is hard to properly distinguish from impacts which would be better understood under the epistemic community and VoC/IPE perspectives. Importantly, private interest groups are not represented in the Committee. Thus, their impact must have been more indirect, through influencing the causal and principled beliefs of epistemic community members with decision-making powers, or through influencing what national regulators perceived as national interest. While interest groups very well might have influenced the national regulatory agencies at the core of the VoC/IPE approach,

this is more likely to have taken place in the national sphere. Since both the transnational governance approach and the epistemic community perspective are preoccupied with transnational interaction, I will thus focus on the link between these two concepts. As has already been mentioned in part 2.1, the existence of a shared arena of interaction in the Basel Committee contributed to the emergence of an epistemic community. This epistemic community did, equal to the big banks that were actively propagating their views towards the Committee, hold the belief that advanced risk management techniques could be incorporated in a new and improved version of the Basel Accord. It is thus probable that these banks contributed to the growing Committee preference for a revision, through the channel identified in part 2.3 as information, although conclusive evidence of this is hard to establish.

It is somewhat easier to investigate the role of transnationally acting interest groups in the policy process taking place after the revision was initiated. At this point in time, more explicit channels of influence had been established, through the comment rounds and workshops arranged by the Committee. Admittedly, a full overview of all groups involved in these does not exist. However, many of the comments received on the second and third consultative packages, have been made publicly accessible. When investigating these, it becomes evident that a significant proportion of those submitting comments were representatives of big banks. (BIS 2007a; BIS 2007b).<sup>25</sup> Detailed data on the identity of the actors participating in the Committee's workshops is not available. Actors from the financial industry, as well as academic researches, were however important. Since the main motivation of the workshops was to gain insight in the risk management techniques employed by the industry, the big banks being the major users of such techniques naturally took a prominent place (Norgren 2007 [interview]). Hence, the assumption of a central role of the financial industry, and in particular big banks, is justified both in the case of the comment rounds and the workshops.

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<sup>25</sup> Admittedly, these were by no means the only actors participating with comments. The comments had a surprisingly broad scope of origin, and included both central banks and regulatory agencies from countries not represented in the Basel Committee, associations of smaller banks, as well as representatives of associations for non-financial industries and trade-unions (BIS 2007a; BIS 2007b). The assumption that big banks participated extensively, nevertheless holds.

The next question follows naturally: Which type of influence, if any, did these actors have on the policy process? Two possibilities have been outlined: Information and capture. Concerning the former, it has already been argued that there are good and legitimate reasons for why the Committee should seek information from the industry, as banks possessed unique knowledge of risk management techniques. When considering the evidence from the policy process of Basel II, we do indeed find examples of such informative use of contacts with industry actors. Noteworthy, the workshops of the Committee were especially focused on issues marked by high technical uncertainty. (Norgren 2007 [interview]). This corresponds with the notion of involvement as a vehicle for information seeking, since the incentive to search for information is greatest when uncertainty is high. The evidence furthermore supports the notion that such information seeking had an actual effect on the policymaking process. Topics such as IRB, and operational risk, which were marked both by uncertainty and by involvement of external actors, went through significant changes in the course of the three consultative packages.

This perception was confirmed by Claes Norgren, who emphasized the usefulness of the information acquired through workshops and comment rounds for the development of the new accord. He especially highlighted the treatment of securitization as an issue where such information proved to be of great use. Although experts of the Federal Reserve System (the US central bank) had significant knowledge of the intricacies of the practice, much of the expertise was held by employees of the financial industry. Especially for European regulators, which lacked in-house competencies on securitization, the ability to draw on industry sources was therefore useful. In Mr Norgren's words, it was of great utility to the process to 'compare the arguments from the theorists of the Fed with those of industry practitioners.' (Norgren 2007 [interview]). Furthermore, in a year 2000 speech, Mr McDonough praised the interest in the policy process shown through the preceding comment round, and stated that the respondents had raised 'a number of important concerns and questions that the Committee is reviewing and considering carefully'. (McDonough 2000). It thus seems plausible that private actors

from the financial industry had impact on the development of the policy process, through the channel of influence identified as information.

Investigating the latter possible type of influence, i.e. capture, is immensely difficult. Regulatory capture indicates that the regulatory agency pursues the interest of a particular sub-group, such as the financial industry, over that of the general public. If policymakers deliberately pursued such a strategy, they would certainly not tell it, nor leave any trace of their activities. We thus need to find a more indirect research strategy. One useful proxy would have been to investigate whether involvement of interest groups was strongest in issues where uncertainty was high, or in contrast, was strongest in issue areas with high distributional consequences. In the case of the former, the notion of involvement as information seeking would be supported, in the case of the latter, that of capture. Unfortunately for the analysis, both are true. Interest groups were strongest involved on the issues of IRB and operational risk. (Norgren 2007 [interview]). These were both marked by high uncertainty, as well as by relatively high distributional impact.

Another strategy is based on comparing the final version of the accord, with the properties of the policy programme of the epistemic community. Admittedly, both of these entail some redistribution. The increased focus on risk management, which is the central focus of the epistemic community's policy programme, benefits the more sophisticated banks. This could however plausibly be explained as a side effect of a measure which really was taken to improve the stability and efficiency of the world's financial system. That the ability to utilize risk management techniques increases with size and sophistication is a technical fact which cannot be negotiated away. In the words of the director of the Norwegian Financial Services Association: 'Big banks benefit...but there is a reality behind' (Hageler 2007 [interview]). Furthermore, according to Claes Norgren, the Committee viewed it as likely that risk management techniques which at the time only were accessible to the big sophisticated banks which had developed them, later would become vendible, i.e. that it would be possible to purchase such services in the market at a rate affordable also for smaller banks (Norgren 2007 [inter-



view]). The best indication of capture in the policy process is thus if we could identify a part of the final accord which benefits a transnational interest group involved in the policy process, which is inconsistent with the policy programme of the epistemic community, and which could not be explained as a concession to national preferences as those identified under the VoC/IPE perspective. No such elements could be found. It is consequently not likely that the policy process of Basel II has been influenced by capture by any transnational interest groups.

The other actor considered under the transnational governance approach is as mentioned the EU. The data material on this topic is scarce; some conclusions could nonetheless be drawn. At a very early stage in the reform process, i.e. before the revision decision was agreed upon, there is little evidence to support any role of the EU. The Union neither seems to have had any coherent, articulated interest in the future of the Basel Accord, nor any proper channels of influence. This was however to change. The Basel II policy process coincided with the so-called Lamfalussy process, an extensive EU effort to improve the quality of the Union's financial industries. The reform of the Basel Accord therefore fitted well with overall EU priorities. Consequently, the Commission did at an early stage voice its intentions to use Basel II as a template for a pending EU directive on capital adequacy. This directive would be implemented by all banks in every EU member state. Through this move, the Union transformed itself to an important player in the policy process. Again, the question arises, through which channels the EU could have influenced the policy process. Two possibilities were suggested. The first is the observatory status of the EU Commission and of the ECB in the Basel Committee. The other is the overlap between EU- and Committee membership. It is not possible to find any direct influence through the EU Commission and ECB's participation in the Basel Committee. As observers, they did not hold any decision-making powers. Although difficult to investigate, it is nevertheless not unlikely that the direct involvement of these institutions contributed to further embed the reform process in the EU system, and thus, to strengthen the interest in the policy reform among actors in the EU system.

However, of much greater importance for the process in the Basel Committee was, according to Claes Norgren, the role of the EU as a parallel arena of policy development. This feature was a result of the overlapping membership structure of the EU and the Basel Committee, and of the EU's intention to implement a directive based on the guidelines of Basel II. As a result of this intention, the process of reaching an agreement on how the final accord could be implemented in the EU went in parallel with the process in Basel, through regular meetings in the Committee of European Banking Supervisors (CEBS). This had two effects on the policy process. The first is related to the game between national regulators in the Basel Committee. Simply speaking, it contributed to shift the bargaining power in Europe's favour. As argued in part 3.2, bargaining between conflicting national interests was a central part of the policymaking process of Basel II. In the eyes of Mr Norgren, the parallel process in the CEBS contributed to strengthen 'double member states' (i.e. those being both EU and Basel Committee members), especially towards the US. (Norgren 2007 [interview]). As we could remember from part 3.2, a major source of bargaining power in international regime building is the ability to inflict costs on the counterparties. One such cost-infliction strategy is to defect from the common framework, to pursue a unilateral strategy. According to this logic, the Europeans significantly increased their weight in the negotiations, since they so strongly had committed themselves to implement the new framework. It was signalled that Europe under any circumstances would go on with its capital adequacy directive. The shift of bargaining power entailed by this could be understood when we compare with the policy process behind Basel I. In that process, the implicit threat of closing American and British markets to non-compliant countries was instrumental in pushing the agreement through. (Oatley & Nabors 1998). However, with the strong EU commitment to the revision, it was in fact the Americans that risked being left outside a block of countries with substantial financial clout.

The second effect is more subtle, and is connected to the interaction between the debates in the CEBS and those in the Basel Committee. One possible articulation of this would have been to use the CEBS as a forum for coordinating positions before the

meetings in Basel. The evidence does however not support this assumption. EU member states did on numerous occasions hold diverging positions in the Basel Committee, e.g. on contentious topics such as Pfandbriefe and commercial mortgages. Nevertheless, we could envision a weaker impact, through the ability of the CEBS to function as a forum to facilitate partial convergence of understandings. Europe encompassed a multitude of regulatory traditions, and was consequently a much more heterogeneous actor than the US. According to Mr Norgren, the parallel negotiations in the CEBS contributed to structure the debate in Europe, and thereby to enable a common framework for negotiations with the Americans. Rather than a one-off coordination in the CEBS before embarking on the negotiations in Basel, this was, however, a long-drawn dynamic process of interaction, marked by shifting sequels of negotiations in the CEBS and Basel respectively. (Norgren 2007 [interview]). The categorisation of influence through either information provision or capture does not fit well with the potential impact of the EU as it has been outlined here. Rather, it approaches the VoC/IPE perspective, as something that strengthened the bargaining power of EU member states in the negotiations of the Committee. The evidence analysed in this thesis is scanty when it comes to the impact of the EU; a full understanding of the dynamic between the EU and the Committee can therefore not be developed. We could nevertheless conclude that it is likely that the EU had an effect on the final outcome of the policy process. Considering the gaps in the literature on this subject, this should be an interesting topic for further research.

### **3.4: Bringing the perspectives together**

As we have seen, the epistemic community perspective, the VoC/IPE, and the transnational governance approach, each in their way explain parts of the policy process behind Basel II. The time has now come to create a more comprehensive picture, and thereby, to answer the three questions of why the accord was changed, and got the final shape it got, of which actors had influence on the process, and of which mode the policy process followed. For this purpose, the hypotheses developed in part 2 will be

compared against each other. For each question, I will make a quick summary of the predictions made by the theoretical perspectives, before examining them in the light of the analyses performed in part 3.1, 3.2, and 3.3.

The first question to be considered is *why*. As we remember, the epistemic community perspective predicted that the emergence of an epistemic community was behind Basel II, and that this epistemic community shaped the policy process. In contrast, VoC/IPE claimed the policy change to be a result of changes in the financial structure of important member states, or changes of the relative power relations between member states. It furthermore claimed that national interests and power resources shaped the policy process. The transnational governance approach was not included to give a full, alternative explanation of the causes of Basel II, but rather, to illustrate that the revision of the accord was influenced by groups without decision-making powers in the Committee. This influence was predicted either to take the shape of information provision, or, in contrast, regulatory capture.

Having considered the empirical evidence, the question is now: Which perspective has the strongest explanatory power? There is indeed strong support for the perception that an epistemic community was instrumental in initiating and shaping Basel II. As was argued in part 3.1, the world saw the emergence of an epistemic community in the field of banking regulations, in the years following the 1988 accord. The policy programme of this epistemic community emphasized increased risk sensitivity and increased interactivity of regulation and supervision. The very same features constitute the core characteristics of the final version of Basel II. Furthermore, it was argued that central policy actors such as Claes Norgren and Committee chairman William J. McDonough shared the views of this policy programme, and were motivated by them in the policy making process. Hence, the epistemic community approach is supported both at a macro level, i.e. when the policy programme is compared with the final outcome of the policy process, and at a micro level, i.e. when the motivation of key individual policy actors is investigated.

Notwithstanding, we could also find support for the ideas of the VoC/IPE perspective. It was argued that especially US national interest changed in the period preceding 1998. This was largely attributed to the increased importance of securitization in American financial markets. Seeing the effectiveness of the existing regulations undermined, American regulators increasingly came to see a revision as their national interest. Germany in contrast, saw less such need. An implicit fear of the costs of a potential unilateral move by the US did, however, make it become a vocal supporter of change. Furthermore, the policy process following the 1998 initiation was partially characterised by loud political struggles between certain member states, especially Germany and the US.

How, then, do the two perspectives stand against each other? When analysing the period before the initiation of the revision, a clear separation between the epistemic community approach and VoC/IPE is difficult to make. After all, the policymakers identified as members of the epistemic community, such as Claes Norgren and William J. McDonough, were also representatives of national regulatory agencies. One feature does however strengthen the epistemic community perspective. This is the absence of a clear interstate conflict in the years preceding 1998. The situation was not one of strong pressure for change in some states, and virulent resistance in others. Instead, there was a growing convergence of understanding across national borders, of the shortcomings of the 1988 accord. This entailed an understanding of the need to do something, sooner or later, with the existing framework.

Such a convergence of understandings is consistent with the logic of the epistemic community approach. Admittedly, some states, especially the US, had a domestic financial structure that made them feel the need for a change more urgent than what certain other states did. This partial convergence of, on the one hand, the policy programme of the epistemic community with, on the other, the national interest of a powerful member state, is certainly likely to have added further momentum to the developments eventually leading to the revision. The perception that the existing accord was flawed was however far too broadly held for us to speak of one homogeneous group of

countries propagating reform, and another one opposing it. Furthermore, rather than open, articulated resistance towards change, there was more of a mild scepticism towards the need to embark on a long and costly reform process at that particular point in time. Thus, while there among certain actors initially was a lower perception of the urgency of reform, there was little real resistance towards the reform programme's rationale. The decision to revise Basel II thus seems to stem more from a shared understanding originating in observations of the effects of the 1988 accord, than from successful pressure from powerful member states with a strong national interest in policy reform. Consequently, for the period preceding the 1998 initiation, the epistemic community perspective has stronger explanatory power than the VoC/IPE approach.

For the period between the 1998 initiation and the 2004 submittance of the final draft, i.e. in the policymaking phase, a demarcation between epistemic community- and VoC/IPE-related elements could more clearly be drawn. The evidence supports both perspectives, albeit as explanations of different elements of the accord. As was argued in part 3.1, the policy programme of the epistemic community emphasized use of risk management techniques in the calculation of capital requirements, as well as an interactive approach to supervision of banks. A success of the epistemic community in influencing policy would indicate that these elements are clearly visible in the final version of the revised accord. Likewise, if national regulators had success in promoting narrow national interests in the Committee, this would be visible as elements of the final accord that are senseless when held against the epistemic community policy programme, but that could be understood as rational when compared with the national interest of any of the member states of the Committee. As elaborated on in part 1.2 and 3.1, the overall features of Basel II are indeed consistent with the policy programme of the epistemic community. The new accord incorporates both a strongly increased focus on risk management, as well as prescriptions for a much more interactive mode of supervision. Thus, the claim that the theory of epistemic communities explains why the accord got the shape it got, is supported in the case of the major, overall characteristics of the accord.

However, when we look into the details, we actually do find aspects that do not make sense when compared against the epistemic community policy programme. This especially concerns the special clauses for commercial mortgages, and for loans to SMEs. These were seen as vital to the survival of the German financial and industrial system. Consequently, German officials employed substantial power resources to secure concessions, such as, in the case of the SME loan controversy, the threat to block the whole policy process. Indeed, the special provisions for commercial mortgages were confirmed by Claes Norgren to have been perceived as nothing else than a pure political concession to allow further progress on more important issues. Thus, also the VoC/IPE perspective has explanatory power towards the question of why the accord got the shape it got. Its explanatory power is however at a different level than that of the epistemic community perspective. While the latter concept explains the overall, important features of the accord, the former explains a bundle of ‘awkward’ details, of less importance for the future of the global financial markets.

The final perspective tested, was that of transnational governance. This was introduced not to rival the two other theoretical perspectives, but rather, to be a complement fit to promote a deeper understanding of issues ignored by the two other perspectives. Consequently, I consider it separately, rather than together with the two other perspectives. Its core argument in respect of the why-question was that the decision to revise the Basel Accord, as well as the final outcome of the reform, was influenced by groups without decision-making powers in the Basel Committee. This influence was predicted to have gone either through provision of information to the policymakers, or through capture. As was argued in part 3.3, the influence of such actors in the period preceding the initiation of the revision was extremely limited. The only exception identified was a possible influence by big banks through provision of information, which in turn contributed to shape the policy programme of the epistemic community. In the policymaking phase, i.e. after 1998, a greater potential for influence was however identified. While no evidence could be found of capture, big banks in particular were extensively involved in providing the Committee with information, through workshops and through comments on the three preliminary drafts. This activity was particularly in-

tense in relation to topics marked by uncertainty. Mr Norgren emphasized the usefulness of this information for the policymaking process, at least for questions concerned with securitization.

The last issue of relevance for the why-question is the role of the EU. As was outlined in part 3.3, the influence of this institution on the policy process has been very subtle; it was nevertheless emphasized by those interviewed for this thesis. It seems like its core impact was the strengthened position it gave double member states, i.e. those both in the Union and in the Committee, through the parallel policy process run by the CEBS. Evidence related to this issue is however too patchy for any final conclusions to be drawn.

The second question sought answered by this thesis is *who* i.e. which actors were involved in the policymaking process. Whereas the epistemic community perspective centred on experts belonging to an epistemic community, the VoC/IPE approach focused on national representatives. The transnational governance approach did in contrast view the policy process as something shaped by a multitude of actors. Since some of these actors are covered by the epistemic community and VoC/IPE perspectives, attention was under the transnational governance perspective however directed towards transnational actors external to the Basel Committee; transnationally acting interest groups and the EU were highlighted. The role of these groups has already been elaborated on above; a thorough investigation is thus not necessary here. It is sufficient to say that all the groups identified by all three perspectives have been involved in the policy process. Of particular importance for the final outcome of the process were the experts acting according to the epistemic community's policy programme, but also regulators pursuing narrow national interests, interest groups providing information, as well as the EU, have played a role. Thus, the best description seems to be made by the transnational governance perspective in its original meaning, i.e. before the demarcation of distinct actors within this perspective was made. A plethora of actors contributed to shape the policy process of Basel II, albeit to a various extent, and through various channels.



This leads us to the third and final question of the thesis, i.e. *how*, or more specifically which mode the policy process followed. The epistemic community perspective predicted the process to be characterised by rational arguing among experts. According to the VoC/IPE approach, it should be marked by bargaining between state actors pursuing national interests. In contrast to both these perspectives, the transnational governance approach viewed policymaking as complex interaction in open, multilevel networks. Again, the evidence from the policy process is mixed. As emphasized in part 3.1, there are strong indications of a prominent role of arguing in the policymaking process of the Committee. The relatively insulated nature of the negotiations enabled a high degree of openness in the mandates of the national negotiators congregating in Basel. As was confirmed by Claes Norgren, this promoted a debating climate conducive to learning, and sharing of information, rather than simple pursuit of predetermined national interests; in his own words: ‘No one presented orders from their superiors’.

Nonetheless, there are equally examples of the type of power exercise characteristic of a policy process marked by bargaining. The most prominent example of this is the explicit German threat to block an agreement being unfavourable to the special needs of SMEs (i.e. the German *Mittelstand*). It is however worth noticing that such open exercise of power was limited to a relatively narrow selection of policies, which were not central to the more important underlying principles of the revision, i.e. to the increased risk sensitivity of capital requirement calculation, and interactivity of supervision. Typically, it concerned relatively narrow policy issues. These were marked by low uncertainty of the impact for individual actors, by high importance to some member states, and by relatively low importance to others.

Finally, we could find some support for the argument made by the transnational governance approach, i.e. that the policy process took the shape of interaction in open, multilevel networks. Again, it is important to remember that this is a complementary rather than a rivalling analytical concept. After all, within these open, multilevel net-

works, both arguing and bargaining is possible. When trying to get an overview of the mode of the policy process of Basel II, the transnational governance perspective nevertheless adds to our understanding, in excess of what could be explained by the two other perspectives. This is related to the involvement of external actors in the policy process, i.e. actors without decision-making powers in the Committee. As already mentioned, the active involvement of such actors is one of the most striking features of the Basel II policy process, as compared with the process behind Basel I. Activity related to the policymaking process took place among a wide range of actors, at multiple levels. One process took place among private actors. In particular representatives of the banking industry actively considered alternative policy options, and tried to promote their favoured options towards the Basel Committee. Another process took place in the EU, where the future implementation of the accord in the EU was debated. And, off course, there was a process in the Basel Committee, as well as at the national level in the Committee member states.

However, not all of these sub-processes had the same ability to influence the paths and outcomes of the overall process of policymaking. National governments could decide the policy preferences of their respective countries, as well as exercise power through the threat of veto. The regulators debating in Basel had authority to make decisions leading to final policy. Those actors which in this thesis have been referred to as external, in particular private actors in the financial industry, were however confined to a more indirect, 'soft' mode of impact. Certainly, they could contribute to expand the number of policy options available to policymakers, through provision of information. Any possibility to veto, or to make policy decisions, was however absent. The multi-level networks shaping policy were therefore highly asymmetric, with actors on some levels having a much more decisive influence than others.

## Concluding remarks

This thesis set forth to create a theoretically informed account of the events leading up to the second Basel Accord. For this purpose, it asked three questions about the policy process taking place in and around the Basel Committee between the mid 1990's and the submittance of the final draft in 2004. Firstly, it was asked *why* the accord was changed and got its final shape. Secondly, the thesis asked *who*, i.e. which actors were involved in the policy process. Finally, it was asked *how*, or more specifically, which mode the policy process followed.

As was argued in part 3.4, dissemination of new policy beliefs, in a transnational epistemic community of bank regulators, explains much of the first question, i.e. why the accord was changed and got its final shape. However, also the power play between diverging national interests has explanatory power, albeit only for relatively minor features, not essential to the overall qualities of the new accord. The results are similar in respect of the *who*-question. Experts adhering to an epistemic community policy programme were among the most important players of the policy process, however, also national representatives acting as agents of more narrow national interests had impact. Furthermore, the policy process has included a wide range of actors external to the Basel Committee. The most important of these were private sector representatives included through workshops and comment rounds, as well as the EU. Finally the analysis contributed to illuminate the *how*-question. The mode of the policy process of Basel II showed to be marked by interaction in multilevel, asymmetric networks.

When summing up the results from this analysis, and considering them against earlier accounts of policymaking in the Basel Committee, four features are particularly striking. The first of these is the emergence of a transnational epistemic community of bank regulators, and the importance of this community for the outcome of the Basel II policy process. While Kapstein (1992) found no evidence of any activity of an epistemic community in the process leading up to Basel I, the evidence analysed in this thesis supports the idea that such a community emerged in the years preceding the ini-

tiation of Basel II. It was argued that a policy programme favouring increased risk sensitivity of regulation, as well as increased interactivity in the overall relationship between regulators and bankers, was adopted by central actors of the Committee, and motivated them in their policy efforts. There is significant congruency between this policy programme and the overall characteristics of the final version of Basel II. Resultantly, the theory of epistemic community provides a strong explanation of the policy process. To employ the dichotomy of knowledge and interest introduced in the introduction to this thesis, knowledge was therefore instrumental in bringing by Basel II.

The second feature is somewhat contradictory to the findings outlined in the paragraph above. It concerns the enduring influence of interest, more specifically of narrow national interests, on policy making in the Basel Committee. Furthermore, it concerns the importance of relative power relations in the international economy. As identified by Kapstein (1992) national interests and exercise of power were the driving elements of the process leading up to the first Basel Accord. In the paragraph above, it was argued that Basel II in contrast was brought by an epistemic community, i.e. by knowledge and rational argumentation. Nevertheless, when analysing the policy process behind Basel II, we could still identify an important role of power and national interests. In particular the underlying conflict between the US and Germany was prominent. The major impact of conflicting national interests does however seem to have been related to relatively minor features of the accord, not as such relevant to the major qualitative changes introduced by Basel II, which particularly are connected to an increase in risk sensitivity and interactivity. Interest has consequently been important, albeit to a lesser extent than knowledge.

The third noticeable feature of the Basel II policy process is the strong involvement of actors external to the Committee. Especially private actors from the financial industry have been deeply involved through comment rounds and workshops. Through provision of information for the decision-making process, they are likely to have affected the final outcome of the accord. In this respect, Basel II is a testament to the growing importance of public-private networks in global policymaking. It thus reflects a gen-

eral trend in the global political economy. (Schuppert 2006). When a policymaking process is expanded to involve actors not deriving their authority from any political body (which necessarily is the case with private actors), an important question arises. This is: Who get their voices heard? The present thesis has not been able to get into the depths of this problem. As the importance of such actors in the policy process now seems clear, this should however be an interesting topic of further research.

The fourth and final feature worth noticing about the Basel II policy process is the role of the EU. This aspect of the Basel Committee's history is significantly under-researched. It was, however, an issue that repeatedly came up in the interviews performed for the purpose of this thesis. The evidence on this part of the policy process was extremely patchy; a clear understanding of the influence of the EU could thus not be established. It was suggested that the major impact of the EU was to strengthen the European member states towards the US. More research is however needed if any conclusive arguments about the EU in the Basel II policy process should be made.

Based on these findings, future research of the policymaking process in the Basel Committee should seek to facilitate a coherent, integrated understanding of how policy is shaped through a mode of broad interaction between all the actors identified in this thesis. The Committee has in the course of the last few decades evolved into a major player in the world economy. Thoroughly understanding its processes and channels of influence is therefore a matter of increasing importance.



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## Appendix: Explanation of risk types covered by Basel II

Three risk types are covered by the new Basel Accord: Credit risk, market risk, and operational risk.

- **Credit risk:** This term describes the classic risk in banking, namely the risk of a debtor not paying back his loan in due time.
- **Market risk:** Indicates the risk of the value of an investment decreasing due to movements in market factors. Normally, four subcategories of such risk are identified: Equity risk (the risk of changes in stock prices), interest rate risk (risk of changes in the interest rate), currency risk (risk of exchange rate movement), and commodity risk (risk of changes in the commodity prices).
- **Operational risk:** Is by the Basel Committee defined as ‘the risk of loss resulting from inadequate or failed internal processes, people and systems, or from external events’. (Basel Committee on Banking Supervision 2006: 144). The term is broad, and could refer to a wide range of risk factors in a bank’s operational environment, including, but not limited to, break down of computer systems, natural disasters, staff sickness, and fraud. An infamous example of operational risk was seen in 1995, when the London based Barings Bank collapsed after having incurred huge losses on the illicit dealings of rogue trader Nick Leeson at the Singapore International Monetary Exchange.