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The Emerging Regime of International Financial Services Regulation

Michael P. Malloy

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I. Introduction

Scholars of U.S. bank regulation have long noted the growing significance of multilateral sources of rule-creation. U.S. adherence to the General Agreement on Trade in Services ("GATS"), including banking services,[1] and U.S. membership in the North American

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1 General Agreement on Trade in Services, Apr. 15, 1994, Agreement Establishing the World Trade Organization, Annex 1B, LEGAL INSTRUMENTS–RESULTS OF THE URUGUAY ROUND vol. 28 (1994), *reprinted in* 33 INT'L LEGAL MATERIALS 44 (1994) [hereinafter GATS]. On the significance of the GATS for bank regulation, see Chantal Thomas,

Free Trade Agreement ("NAFTA"), which includes rules for trade in financial services within the region,[2] will have obvious effects on financial services regulation as these two multilateral regimes continue to mature. Of immediate interest, however, is the influence of the undertakings of the Bank for International Settlements ("BIS"), in which U.S. bank regulators have been participating directly.[3] This article focuses primarily on the capital adequacy rules for internationally active banks developed by the BIS, popularly referred to as "Basel III," which are intended to replace the capital adequacy guidelines in full operation from 1992.[4] The BIS has already had an impact in terms of its active influence on specific mandatory rules in banking regulation[5] that for the present far exceeds that of the GATS and the NAFTA.[6]

Globalization in Financial Services–What Role for GATS?, 21 ANN. REV. BANKING L. 323, 331–33 (2002); Michael P. Malloy, *International Financial Services: An Agenda for the Twenty-First Century*, 15 TRANSNAT'L L. 55, 55–60 (2002) (discussing impact on U.S., foreign, and international baking); Joel P. Trachtman, *Trade in Financial Services Under GATS, NAFTA and the EC: A Regulatory Jurisdiction Analysis*, 34 COLUM. J. TRANSNAT'L L. 37, 52–57 (1996) (discussing goals of GATS and problems they were intended to help solve).

2 North American Free Trade Agreement ("NAFTA"), U.S.-Can.-Mex., Dec. 17, 1992, *reprinted in* 32 INT'L LEGAL MATERIALS. 289–397, 605–779 (entered into force Jan. 1, 1994). It should be noted that a new United States-Mexico-Canada Agreement ("USMCA") entered into force on July 1, 2020. On the significance of the NAFTA for bank regulation, see generally, Art Alcausin Hall, *International Banking Regulation into the 21st Century: Flirting with Revolution*, 21 N.Y.L. SCH. J. INT'L & COMP. L. 41 (2001); Trachtman, *supra* note 1. The newly implemented USMCA had relatively little impact on trade in financial services. Much of the existing NAFTA framework applicable to financial services continues under the USMCA. *See* MICHAEL P. MALLOY, INTERNATIONAL BANKING 26–28 (4th ed. 2019) (discussing NAFTA and its transition to USMCA).

3 *Basel Committee Membership*, BANK FOR INT'L SETTLEMENTS ("BIS"), https://www.bis.org/bcbs/membership.htm [https://perma.cc/7YM5-9HBV] (last updated Dec. 30, 2016).

4 On the development of the original adequacy rules, see generally, Michael P. Malloy, *U.S. International Banking and the New Capital Adequacy Requirements: New, Old and Unexpected*, 7 ANN. REV. BANKING L. 75 (1988).

5 *See, e.g.*, 3 MICHAEL P. MALLOY, BANKING LAW AND REGULATION § 15.02[C][1] (Wolters Kluwer 2d ed. 2011) (noting the "increasing significance" of the BIS Committee on Banking Supervision "as a forum or catalyst for international monetary cooperation and policy development").

6 One reason for the relative influence of the BIS may be that the impact of other multilateral regimes has been blunted by specialized rules and exceptions that limit their binding effect on bank regulatory practices of national regulators. *See, e.g.*, Michael P. Malloy, *Financial Services Regulation After NAFTA*, *in* THE FIRST DECADE OF NAFTA: THE FUTURE OF FREE TRADE IN NORTH AMERICA (Kevin Kennedy ed., 2004) (arguing that

A. Themes

The theme of this article is two-fold. First, given the current significance of the work of the BIS for rule-creation in national bank regulatory systems, it is important to analyze and assess the capital adequacy accord on its own terms. Second, with the example of the capital adequacy rules in mind, the article will suggest that the work of the BIS represents an emerging source of international law applicable to financial services providers operating in international markets.

B. The Bank for International Settlements

The BIS, located in Basel, Switzerland, is a multilateral bank for national central banks.[7] Traditionally, it has been primarily supported by the "Group of Ten" large industrialized democracies ("G-10"), consisting of Belgium, Canada, France, Germany, Italy, Japan, the Netherlands, Sweden, United Kingdom, and the United States, with Switzerland as an additional significant participant.[8] The BIS assists central banks in the transfer and investment of monetary reserves and often plays a role in settling international loan arrangements.[9] Of increasing significance is its role as a forum or catalyst for international monetary cooperation and regulatory policy development.[10]

The failure of Herstatt Bank in Germany and Franklin National Bank in New York in 1974, with financial repercussions throughout the increasingly "internationalized" banking market, led the G-10 to sponsor an informal understanding on the resolution of international bank failures, known as the Basel Concordat, which was finalized in 1975.[11] The Governors of the BIS acknowledged the need to

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"the practical effects of [NAFTA] obligations are likely to emerge only incrementally, and those effects will have an impact largely cushioned by the intervention of reasonable measures domestically imposed for prudential reasons").

7 For extended discussion of the BIS, see MICHAEL P. MALLOY, PRINCIPLES OF BANK REGULATION §§ 9.7-9.9 (3d ed. 2011).

8 *History – Overview*, BIS, https://www.bis.org/about/history.htm [https://perma.cc/88E8-CAS2] (last visited Dec. 18, 2020).

9 *See id*. (discussing roles of BIS).

10 *Id*.

11 BASEL COMM. ON BANKING REGS. & SUPERVISORY PRACTICES, REPORT TO THE GOVERNORS ON THE SUPERVISION OF BANKS' FOREIGN ESTABLISHMENTS (1975), https://www.bis.org/publ/bcbs00a.pdf [https://perma.cc/CN6S-3CWC] [hereinafter CONCORDAT].

establish a framework of multilateral bank supervision, and formed the Committee on Banking Regulations and Supervisory Practices, now known as Basel Committee on Banking Supervision (the Committee).[12] The Committee originally consisted of foreign exchange and supervisory officials from the G-10, but over the course of almost 50 years it has expanded to 45 officials of institutions from 28 jurisdictions.[13]

The Committee promotes cooperation among national regulators—it facilitates the establishment of broadly delineated principles to guide the differing national supervisory systems in establishing their own detailed arrangements.[14] This was the approach taken by the 1975 Concordat in establishing a set of broad principles for the resolution of future bank crises.[15] The generality of the guiding principles articulated in the Concordat proved to be insufficient when Banco Ambrosiano, based in Italy with a subsidiary in Luxembourg, failed in 1982.[16] Italian authorities at first indicated that, from their perspective as "lender of last resort" to the bank, they would honor only Ambrosiano's domestic (*i.e.*, Italian) obligations.[17] This unexpected gap in banking supervision caused great distress in the banking world,[18] even though a large group of creditor banks of the Luxembourg subsidiary did eventually reach a settlement with the Italian central bank involving more than $300 million in subsidiary obligations.[19] One result of the difficulties of

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12 *History of the Basel Committee*, BIS, https://www.bis.org/bcbs/history.htm [https://perma.cc/GC5M-MHBE] (last visited Dec. 18, 2020).

13 *Id.*

14 *Id.*

15 *See generally* CONCORDAT, *supra* note 11.

16 *See, e.g.*, Ethan B. Kapstein, *Architects of Stability? International Cooperation Among Financial Supervisors* 7 (BIS, Working Paper No. 199, Feb. 26, 2006) ("The collapse of Banco Ambrosiano - the 'Pope's bank' - in 1982 had painfully demonstrated the many holes that remained in this nascent supervisory architecture. Who was responsible for providing the lender of last resort function when the subsidiary of a bank collapsed? Was it the home or the host authority? What information were home and host supervisors expected to share across borders; indeed, what were they permitted by law to share?").

17 For a useful analysis of the Banco Ambrosiano collapse and its implications for regulatory policy, see Ulrich Hess, *The Banco Ambrosiano Collapse and the Luxury of National Lenders of Last Resort with International Responsibilities*, 22 N.Y.U. J. INT'L L. & POL. 181, 199–03 (1990) (describing how the banking crisis revealed a number of loopholes and issues with the existing regulatory scheme).

18 *Id*. at 189–90.

19 *Id*.

resolving this multinational bank failure was the revision of the Concordat in 1983.[20] The revision articulated in relatively greater detail supervisory responsibilities with respect to multinational banking enterprises.[21]

Since the issuance of the Basel Concordat, the Committee has given further attention to the problems of supervising transnational banking enterprises. An April 1990 Supplement to the Concordat sought to strengthen the principle of effective information flow between home-country and host-country authorities[22] by making the rules on information transfer more explicit and detailed.

The 1991 scandal surrounding the collapse of the Bank of Credit and Commerce International ("BCCI")[23] subsequently caused the BIS Committee to review the arrangements for coordination of international bank supervision, which had proved inadequate in the events surrounding the BCCI collapse.[24] Hence, in June 1992, the Committee took the further significant step of issuing a report establishing minimum standards on the supervision of international banking enterprises.[25] While the standards were not, on their own terms, binding on states, BIS participating states were expected to implement them, and other states were encouraged to do the same.[26] In the United States, implementation occurred primarily in

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20 BASEL COMM. ON BANKING SUPERVISION ("BCBS"), PRINCIPLES FOR THE SUPERVISION OF BANKS' FOREIGN ESTABLISHMENTS (1983), https://www.bis.org/publ/bcbsc312.pdf [https://perma.cc/VJY5-2T7J] [hereinafter PRINCIPLES FOR SUPERVISION].

21 *See* Duncan E. Alford, *Core Principles for Effective Banking Supervision: An Enforceable International Financial Standard?*, 28 B.C. INT'L & COMP. L. REV. 237, 248 (2005) (explaining that "with the Revised Concordat, the Committee attempted to close the supervisory gaps that existed under the original Concordat and directly address the adequacy of foreign bank regulation").

22 BCBS, INFORMATION FLOWS BETWEEN BANKING SUPERVISORY AUTHORITIES (SUPPLEMENT TO THE CONCORDANT) (1990), https://www.bis.org/publ/bcbsc313.pdf [https://perma.cc/GHD8-FYH9], *reprinted in* MALLOY, *supra* note 2, at 73–76.

23 For a review of the BCCI scandal and the legislative reaction to the scandal in the United States, see RAJ K. BHALA, FOREIGN BANK REGULATION AFTER BCCI (Carolina Academic Press 1994).

24 *See* Alford, *supra* note 21, at 251–55 (discussing weaknesses of revised Concordat in relation to BCCI failure).

25 BCBS, MINIMUM STANDARDS FOR THE SUPERVISION OF INTERNATIONAL BANKING GROUPS AND THEIR CROSS–BORDER ESTABLISHMENT (1992), https://www.bis.org/publ/bcbsc314.pdf [https://perma.cc/4K7A-VQ94], *reprinted in* MALLOY, *supra* note 2, at 76–80 [hereinafter MINIMUM STANDARDS].

26 *Id.* at 77–78.

connection with the enactment of the Federal Deposit Insurance Corporation Improvements Act.[27]

More recently, the Committee, in conjunction with the International Monetary Fund and the International Bank for Reconstruction and Development, developed a set of core principles for effective banking supervision.[28] The original Core Principles consisted of twenty-five basic principles, ranging from preconditions for effective banking supervision (Principle 1) to principles for cross-border banking (Principles 23–25).[29] Significantly, the principles address in detail prudential regulations and requirements (Principles 6-15), which have the effect of requiring careful supervision of management operations and internal controls.[30]

In April 2006, the Committee issued a proposed revision of the Core Principles, which was issued in final form in October 2006.[31] The basic focus remained the same as in the original version, but a new "umbrella principle" advised banks to establish integrated risk management systems across the range of different risks banks face (Principle 7).[32] Criteria for evaluating liquidity (Principle 14), operational (Principle 15), and interest rate risks (Principle 16) were also enhanced,[33] and criteria with respect to money laundering,

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27 *See, e.g.*, 12 U.S.C. § 3105(d)(2)(A) (2018) (requiring approval of U.S. branch of foreign bank and comprehensive supervision of applicant on consolidated basis by home state authorities); § 3105(d)(3)(A) (requiring the same: consent of home state to establishment of U.S. branch as standard of approval by U.S. authorities); § 3105(e)(1)(A) (requiring termination of U.S. office of foreign bank when foreign bank not subject to comprehensive supervision on consolidated basis by home state authorities).

28 BCBS, CORE PRINCIPLES FOR EFFECTIVE BANKING SUPERVISION (1997), https://www.bis.org/publ/bcbs30a.pdf [https://perma.cc/XJ5X-28UZ], *reprinted in* 37 INT'L LEGAL MATERIALS 405 (1998) [hereinafter CORE PRINCIPLES 1997]. The principles were, of course, not binding in themselves, but "serve[d] as a basic reference for supervisory and other public authorities in all countries and internationally." *Id.* at 407.

29 *Id*. at 408, 410.

30 *Id.* at 408–09.

31 *See generally* BCBS, CORE PRINCIPLES METHODOLOGY (2006), https://www.bis.org/publ/bcbs130.pdf [https://perma.cc/AN62-RAHB] [hereinafter CORE PRINCIPLES 2006]; BCBS, COMPARISON BETWEEN THE 1999 AND 2006 VERSIONS OF THE CORE PRINCIPLES METHODOLOGY (2006), https://www.bis.org/publ/bcpmastermapping.pdf [https://perma.cc/9SMA-9MBE]; Daniel Pruzin, *Basel Committee Issues Revised Supervisory Principles for Comment*, BLOOMBERG L. (Apr. 10, 2006) (available by subscription at https://news.bloomberglaw.com [https://perma.cc/UEV7-RQCC]) (discussing proposed revision).

32 CORE PRINCIPLES 2006, *supra* note 31, at 15–17.

33 *Id.* at 23–27.

terrorist financing, and fraud prevention (Principle 18) were strengthened.[34] Bank supervisors from central banks and supervisory agencies in 120 countries endorsed the updated version of the Basel Core Principles.[35]

In September 2012, the Committee published the current version of the revised Core Principles[36] intended—in the wake of the 2008 financial crisis[37]—to ensure effective national regulation and supervision of banks and banking systems under individual national jurisdictions. As of mid-September 2012, the revised Core Principles was endorsed by global banking supervisors and central bankers from more than 100 countries.[38]

C. Capital Adequacy

The BIS was also responsible for what is perhaps the most influential contemporary development in the international supervision of banking—the formulation of uniform guidelines governing the measurement and enforcement of capital adequacy of banks.[39] In U.S. practice, capital adequacy requirements predate the BIS efforts.[40] However, the rules developed under BIS auspices were aimed not only at a capital adequacy regime that would be effective as a purely regulatory matter, but also one that would encourage a

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34 *Id*. at 29–31 (addressing "abuse of financial services").

35 Press Release, BCBS, Bank Supervisors from 120 Countries Endorse Updated International Principles for Effective Banking Supervision (Oct. 5, 2006), https://www.bis.org/press/p061005a.htm [https://perma.cc/AA98-PRU8].

36 CORE PRINCIPLES 1997, *supra* note 28; *see* Daniel Pruzin, *Basel Committee Issues Final Version of Revised Core Principles on Supervision*, BLOOMBERG L. (Sept. 17, 2012) (available by subscription at https://www.bloomberglaw.com/ [https://perma.cc/5TKL-P78Y]) (discussing significance of revised Core Principles).

37 For discussion of the 2008 crisis, see 2 MICHAEL P. MALLOY, BANKING LAW AND REGULATION § 6.02[E] (Wolters Kluwer 2d ed. 2011). *See generally* MICHAEL P. MALLOY, ANATOMY OF A MELTDOWN (Aspen Publishers 2010) (providing analysis and explanation of subprime mortgage market collapse).

38 Pruzin, *supra* note 36.

39 *See generally* BCBS, INTERNATIONAL CONVERGENCE OF CAPITAL MEASUREMENT AND CAPITAL STANDARDS (1988), https://www.bis.org/publ/bcbs04a.pdf [https://perma.cc/DD9B-W6Q7], *reprinted in* 4 FED. BANKING L. REP. (CCH) ¶¶ 47–105 (Nov. 6, 1991) [hereinafter CAPITAL STANDARDS]. For discussion of the BIS capital adequacy rules and their implementation in U.S. law, see MALLOY, *supra* note 7, § 7.8.

40 *See* Malloy, *supra* note 4, at 75–76, 81–87 (discussing pre-BIS regulatory practice).

multilateral convergence of regulatory standards.[41] What is significant in the present context, however, is that the U.S. regulators chose to apply this multilateral regime not just to internationally active banks (as contemplated by the BIS capital guidelines), but to all banks subject to federal regulation.[42]

The guidelines set forth "the details of the agreed framework for measuring capital adequacy and the minimum standard to be achieved which the national supervisory authorities represented on the Committee intend to implement in their respective countries."[43] The basic focus of this multilateral framework was "assessing capital in relation to credit risk (the risk of counterparty failure)."[44] However, the framework acknowledged that "other risks, notably interest rate risk and the investment risk on securities, need[ed] to be taken into account by supervisors in assessing overall capital adequacy."[45] The framework consisted of a minimum required ratio of certain specified constituents of capital to risk-weighted assets.[46] In this context, "capital" has two types of constituents: "core capital"[47] and "supplementary capital."[48] Core capital, the so-called "Tier 1" of capital elements, consists of: (i) equity capital[49] and (ii)

41 *About BIS - Overview*, BIS, https://www.bis.org/about/index.htm?m=1%7C1 [https://perma.cc/MJ28-7DTW] (last visited Dec. 18, 2020) (identifying the BIS institutional mission as "to serve central banks in their pursuit of monetary and financial stability, *to foster international cooperation* in those areas and to act as a bank for central banks") (emphasis added).

42 *See* 12 C.F.R. pt. 3, App. A, § 1(b)(2) (2020) (explaining that Comptroller's risk-based capital guidelines "apply to all national banks"); *id.* pt. 208, App. A, § I (applying Federal Reserve's risk-based capital guidelines "to all state member banks on a consolidated basis"); *id.* pt. 325, App. A (applying FDIC's risk-based capital maintenance rules "to all FDIC-insured state-chartered banks . . . that are not members of the Federal Reserve System . . . regardless of size").

43 CAPITAL STANDARDS, *supra* note 39, at 1.

44 *Id*. at 2.

45 *Id*.

46 For detailed discussion of the minimum required ratio and its calculation, see Malloy, *supra* note 4, at 84–87.

47 *See* CAPITAL STANDARDS, *supra* note 39, at 3-4 (discussing meaning of "core capital"); *id.* at 17, Annex 1 (defining capital in terms of capital base after transitional period).

48 *See id.* at 4-7 (discussing meaning of "supplementary capital"); *id.* at 17, Annex 1 (defining capital in terms of capital base after transitional period).

49 For these purposes, "equity capital" is defined as "[i]ssued and fully paid ordinary shares/common stock and non-cumulative perpetual preferred stock (but excluding cumulative preferred stock)." *Id.* at 3; *see also id.* at 18 § D(i) (defining "Tier 1" capital elements). In the case of consolidated accounts, Tier 1 capital would also include minority

disclosed reserves from post-tax earnings.[50]

The eligible constituents of Tier 1 and supplementary capital (the so-called "Tier 2" capital) are subject to certain deductions under the framework.[51] The amount of goodwill must be deducted from the figure for Tier 1 capital.[52] The amount of investments in unconsolidated banking and financial subsidiaries, if any,[53] must be deducted from the total capital base.[54] The Committee considered, but ultimately rejected, requiring deduction of banks' holdings of capital issued by other banks or depository institutions.[55] Nevertheless, the framework does reflect the agreement that individual supervisory authorities retain the discretion to require such deductions.[56] If no deduction is applied, such holdings are required to bear an asset risk weight of 100 percent for purposes of assessing capital adequacy of the holding bank.[57]

The framework endorsed a risk-weighted approach to the assets denominator of the capital-assets ratio.[58] The framework established a relatively simple methodology for risk-weighting, with only five risk weights being employed.[59] Essentially, the methodology

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interests in the equity of subsidiaries of the bank that are less than wholly owned. *Id.*

50 *Id.* at 3-4. For these purposes, disclosed reserves are reserves that are "created or increased by appropriations of retained earnings or other surplus, *e.g.* share premiums, retained profit, general reserves and legal reserves." *Id.* at 18. Tier 1 does not include revaluation reserves. *Id.*

51 *See id.* at 7.

52 *Id.*

53 The framework generally assumes as the normal practice that subsidiaries will be consolidated for the purpose of assessing capital adequacy, but "[w]here this is not done, deduction is essential to prevent multiple use of the same capital resources in different parts of [a banking] group." CAPITAL STANDARDS, *supra* note 39, at 7.

54 *Id*.

55 *See id.*

56 Conceivably, these discretionary policies may require deduction of the amount of all such holdings, holdings to the extent that they exceed some determined limit in relation to the holding bank's or the issuing bank's capital, or on a case-by-case basis. The framework also reflected the agreement that, "in applying these policies, member countries [should] consider that reciprocal cross-holdings of bank capital designed artificially to inflate the capital position of the banks concerned should not be permitted." *Id.*

57 *Id.* at 8.

58 *Id.*

59 *See* CAPITAL STANDARDS, *supra* note 39, at 21-22 (establishing risk weights by categories of on-balance-sheet asset).

effectively captured only credit risk.[60] It was left to the discretion of individual supervisory authorities to decide whether to attempt to account for more methodologically difficult types of risk, such as investment risk, interest rate risk, exchange rate risk or concentration risk.[61] Furthermore, the individual supervisory authorities also retained discretion to supplement the framework's risk-weighted methodology with "other methods of capital measurement,"[62] such as the mandated capital-assets ratios previously established by individual national regulators. To account for country transfer risk, the Committee adopted an approach that applied differing risk weights to defined groups of countries.[63]

The framework also recognized the importance of bringing off-

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60 *Id.* at 8.

61 *Id.* at 8-9.

62 *Id.* at 8.

63 *Id.* at 10.

> [T]he Committee has concluded that a defined group of countries should be adopted as the basis for applying differential weighting coefficients[.] The framework also recognizes the importance of and that this group should be full members of the OECD or countries which have concluded special arrangements with the [International Monetary Fund] associated with the Fund's General Arrangements to Borrow . . . .
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> . . . This decision has the following consequences for the weighting structure. Claims on central governments within the OECD will attract a zero weight (or a low weight if the national supervisory authority elects to incorporate interest rate risk); and claims on OECD non-central government public-sector entities will attract a low weight . . . . Claims on central governments and central banks outside the OECD will also attract a zero weight (or a low weight if the national supervisory authority elects to incorporate investment risk), provided such claims are denominated in the national currency and funded by liabilities in the same currency . . . .
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> . . . As regards the treatment of interbank claims, in order to preserve the efficiency and liquidity of the international interbank market[,] there will be no differentiation between short- term claims on banks incorporated within or outside the OECD. However, the Committee draws a distinction between . . . short-term placements with other banks . . . and . . . longer-term cross-border loans to banks which are often associated with particular transactions and carry greater transfer and/or credit risks. A 20 per cent [*sic*] weight will therefore be applied to claims on all banks, wherever incorporated, with a residual maturity of up to an[d] including one year; longer-term claims on OECD incorporated banks will be weighted at 20 per cent [*sic*]; and longer-term claims on banks incorporated outside the OECD will be weighted at 100 percent.

Id.

balance-sheet risk into the analysis of capital adequacy.[64] All categories of off-balance-sheet risk were brought within the framework, by conversion into appropriate credit risk equivalents.[65]

Uncertainty remained about the appropriate approach to items exposed to significant interest-rate and exchange-rate related risk, such as swaps, options and futures.[66] As to these contingencies, the framework took the position that special treatment was necessary, "because banks are not exposed to credit risk for the full face value of their contracts, but only to the cost of replacing the cash flow if the counterparty defaults."[67]

Once the credit equivalent amounts of such contingencies have been calculated, the amounts are to be weighted in accordance with the risk weights applicable to the category of counterparties involved.[68] However, in anticipation of the fact that most counterparties in the market for such contingencies, particularly long-term contracts, "tend to be first-class names,"[69] the Final Report reflected general agreement that such contingencies would be assigned a 50 percent risk weight, rather than the 100 percent risk weight that might otherwise be applicable.[70]

The final element in the risk-weighted methodology, as with any capital-assets ratio requirement, is the required minimum level of the ratio.[71] As the proposed version of this multilateral agreement was taking shape, it was generally agreed that specifying a target ratio was desirable before the proposed framework was circulated at the national level for consultation and discussion.[72] After further consultations and study of the proposed version, the final agreement was reached and the framework adopted a target standard ratio of eight percent, of which core capital must constitute at least four

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64 *See id.* at 12-13 (discussing treatment of off-balance-sheet engagements).

65 CAPITAL STANDARDS, *supra* note 39, at 23-24, 51 (establishing credit conversion factors for off-balance-sheet items).

66 *See id.* at 13.

67 *Id*.

68 *Id.*

69 *Id*. at 27.

70 *Id.* However, some member countries have apparently reserved the right to apply the full 100 percent risk weight. *See id.* at 27 n. 9.

71 CAPITAL STANDARDS, *supra* note 39, at 28.

72 *See id.* at 14.

percent.[73] This target ratio became fully applicable at year-end 1992.[74]

The Basel Committee has continued to refine the details and mechanics of risk management and supervision.[75] Correspondingly, implementation of the guidelines in the United States has not been a static project; the guidelines have been the subject of continuous reassessment and refinement by the regulators.[76] By the mid-1990s,

73 *Id.*

74 *Id.*

75 *See, e.g.*, BCBS, BASEL CAPITAL ACCORD: THE TREATMENT OF THE CREDIT RISK ASSOCIATED WITH CERTAIN OFF-BALANCE-SHEET ITEMS (1994), https://www.bis.org/publ/bcbs12a.pdf [https://perma.cc/3DDW-PE6W]; BCBS, RISK MANAGEMENT GUIDELINES FOR DERIVATIVES (1994), https://www.bis.org/publ/bcbsc211.pdf [https://perma.cc/7RMV-D7AR]; BCBS, AMENDMENT TO THE CAPITAL ACCORD OF JULY 1988 (1994), https://www.bis.org/publ/bcbs12b.pdf [https://perma.cc/7GYC-4WH7]; BCBS, PRUDENTIAL SUPERVISION OF BANKS' DERIVATIVES ACTIVITIES (1994), https://www.bis.org/publ/bcbs14.pdf [https://perma.cc/QT79-PJU2]; BCBS, BASEL CAPITAL ACCORD: TREATMENT OF POTENTIAL EXPOSURE FOR OFF-BALANCE-SHEET ITEMS (1995), https://www.bis.org/publ/bcbs18.pdf [https://perma.cc/4WTT-H2U7]; BCBS, AN INTERNAL MODEL-BASED APPROACH TO MARKET RISK CAPITAL REQUIREMENTS (1995), https://www.bis.org/publ/bcbs17.pdf [https://perma.cc/8LR9-56P2]; BCBS, PUBLIC DISCLOSURE OF THE TRADING AND DERIVATIVES ACTIVITIES OF BANKS AND SECURITIES FIRMS (1995), https://www.bis.org/publ/bcbs21.pdf [https://perma.cc/V7Y2-NHR4]; BCBS, SUPERVISORY FRAMEWORK FOR THE USE OF 'BACKTESTING' IN CONJUNCTION WITH THE INTERNAL MODELS APPROACH TO MARKET RISK CAPITAL REQUIREMENTS (1996), https://www.bis.org/publ/bcbs22.pdf [https://perma.cc/8RRX-NHBE]; BCBS, AMENDMENT TO THE BASEL CAPITAL ACCORD TO INCORPORATE MARKET RISKS (1996), https://www.bis.org/publ/bcbs24.pdf [https://perma.cc/2K2P-X4RR]; BCBS, INTERPRETATION OF THE CAPITAL ACCORD FOR THE MULTILATERAL NETTING OF FORWARD VALUE FOREIGN EXCHANGE TRANSACTIONS (1996), https://www.bis.org/publ/bcbs25.pdf [https://perma.cc/4JBC-B8QS]; BCBS, PRINCIPLES FOR THE MANAGEMENT AND SUPERVISION OF INTEREST RATE RISK (2001), https://www.bis.org/publ/bcbsca09.pdf [https://perma.cc/5GSZ-H8YZ]. The Basel Committee asked for comment by October 31, 2003, on revised interest rate risk principles as part of its larger work on developing new international bank capital standards, and made subsequent changes in 2004 and again in 2016. *Basel Committee Asks for Comment on Revised Interest Rate Risk Principles*, BLOOMBERG L. (Sept. 8, 2003) (available by subscription at https://www.bloomberglaw.com [https://perma.cc/HT6Y-K2BG]); BCBS, PRINCIPLES FOR MANAGEMENT AND SUPERVISION OF INTEREST RATE RISK (2003), https://www.bis.org/publ/bcbs102.pdf [https://perma.cc/WJ7R-X3VQ] (providing a revised consultative paper and a summary explanation concerning the proposal); BCBS, PRINCIPLES FOR MANAGEMENT AND SUPERVISION OF INTEREST RATE RISK (2004), https://www.bis.org/publ/bcbs108.pdf [https://perma.cc/FV8B-N5DH] (providing the 2004 Principles); BCBS, PRINCIPLES FOR MANAGEMENT AND SUPERVISION OF INTEREST RATE RISK (2016), https://www.bis.org/bcbs/publ/d368.htm [https://perma.cc/X7XD-GNBX] (providing the 2016 version).

76 *See, e.g.*, Risk-Based Capital Standards, 62 Fed. Reg. 55686 (Oct. 27, 1997)

the agencies were seriously focusing upon management of interest-rate risk, which was not within the purview of the original guidelines.[77] Similarly, the regulators have folded market-risk provisions into the framework of the guidelines.[78]

II. Major Revisions of the Capital Accord

A. Basel II

The capital adequacy methodology exhibited some serious shortcomings. First, the framework primarily recognized only a narrow, though very significant, type of risk—credit risk, *i.e.*, the

(proposing uniform treatment of certain construction and real estate loans and investments in mutual funds; simplifying Tier 1 capital standards); Risk-Based Capital Standards, 62 Fed. Reg. 55692 (Oct. 27, 1997) (proposing similar amendments with respect to treatment of capital of bank holding companies); Risk-Based Capital Standards; Recourse and Direct Credit Substitutes, 62 Fed. Reg. 59944 (Nov. 5, 1997) (proposing regulatory capital treatment of recourse obligations and direct credit substitutes); Risk-Based Capital Standards, 64 Fed. Reg. 10194 (Mar. 2, 1999) (providing OCC, Fed, FDIC and OTS rules for construction loans on presold residential properties, junior liens on one- to four-family residential properties, investments in mutual funds, and tier 1 leverage ratio); Risk-Based Capital Standards, 64 Fed. Reg. 10201 (Mar. 2, 1999) (corresponding Fed rule applicable to bank holding companies); Risk-Based Capital Standards; Recourse and Direct Credit Substitutes, 65 Fed. Reg. 12320 (Mar. 8, 2000) (proposing changes in risk-based capital standards to address recourse obligations and direct credit substitutes); Bank Holding Companies and Changes in Bank Control, 65 Fed. Reg. 16480 (Mar. 28, 2000) proposing regulatory capital treatment of certain investments in nonfinancial companies by bank holding companies); Risk-Based Capital Standards: Claims on Securities Firms, 67 Fed. Reg. 16971 (Apr. 9, 2002) (reducing risk weight applicable to claims on, and claims guaranteed by, qualifying U.S. securities firms and securities firms incorporated in OECD member countries from 100 percent to twenty percent; conforming FDIC and OTS rules to existing OCC and Fed to permit zero percent risk weight for certain claims on qualifying securities firms collateralized by cash on deposit in lending institution or by securities issued or guaranteed by the United States or other OECD central governments); Risk-Based Capital Guidelines, 68 Fed. Reg. 56530 (Oct. 1, 2003) (issuing interim final rule to remove consolidated asset-backed commercial paper program assets from risk-weighted asset bases for purpose of calculating risk-based capital ratios).

77 *See, e.g.*, Joint Agency Policy Statement: Interest Rate Risk, 61 Fed. Reg. 33,166 (June 26, 1996) (publishing OCC, FRS & FDIC joint policy statement providing guidance on sound practices for managing interest rate risk). *But see* Capital: Qualifying Mortgage Loan, Interest Rate Risk Component, and Miscellaneous Changes, 67 Fed. Reg. 31,722 (May 10, 2002) (codified at 12 C.F.R. §§ 516.40(a)(2), 567.1, 567.5(b)(4), 567.6(a)(1)(iv)(G)-(H); *removing* § 567.7) (imposing 50 percent risk weight for certain qualifying mortgage loans; eliminating interest rate risk component of risk-based capital regulations; making technical amendments).

78 *See, e.g.*, Risk-Based Capital Standards: Market Risk, 62 Fed. Reg. 68064 (Dec. 30, 1997) (amending market risk provisions in risk-based capital standards).

risk of counterparty failure.[79] Over time, the methodology was refined to fold in interest-rate risks and exchange-rate risk.[80] However, the methodology still did not include any adjustment for internal or "operational" risk.[81] This type of risk focuses on a bank's vulnerability to poor management of asset risks, which is of course very important for safety and soundness purposes.[82]

Second, the methodology for risk-weighting was technically rudimentary. Five basic risk weights—0, 10, 20, 50 and 100 percent of asset value—were available for all types of assets and all types of counterparties.[83] This arrangement produced such anomalous results since it applied the same risk weight to a commercial loan to a small business operating a local retail computer store and a commercial loan to a major dot.com corporation, despite the obvious differences in the relative risks involved in the two borrowers.

Third, the framework did not take into account the dramatic changes in the contours of the banking market itself. These changes included consolidation in holding company patterns of ownership and control of increasingly diversified financial services

79 For extensive discussion of the types of risk relevant to the conduct of the business of banking, see BCBS, CORE PRINCIPLES FOR EFFECTIVE BANKING SUPERVISION, § IV.A (2012), https://www.bis.org/publ/bcbs230.pdf [https://perma.cc/NQ3J-NSGL].

80 *See, e.g.*, *id.* (citing revisions in methodology to account for interest rate and exchange rate risks).

81 The term *operational risk* may be defined as "the risk of direct or indirect loss resulting from inadequate or failed internal processes, people and systems or from external events." BCBS, THE NEW BASEL CAPITAL ACCORD 118 n. 62 (2001), https://www.bis.org/publ/bcbsca03.pdf [https://perma.cc/8U47-ZFTG] [hereinafter ACCORD]. As used in the BIS proposed Accord, the term does not include strategic and reputational risk. *Id*. For discussion of reputational risk, see CORE PRINCIPLES 1997*, supra* note 28, at 22. A working paper of the BIS Committee's Risk Management Group has proposed the deletion of the phrase "direct or indirect" from the definition of operational loss, because it was too vague. BCBS, WORKING PAPER ON THE REGULATORY TREATMENT OF OPERATIONAL RISK 2 (2001), https://www.bis.org/publ/bcbs_wp8.pdf [https://perma.cc/U5DQ-MHAN] [hereinafter RMG WORKING PAPER]. In June 2002, the Basel Committee announced that it would be seeking detailed information from internationally active banks with respect to operational risk exposures for 2001. Daniel Pruzin, *Basel Committee Seeks More Bank Data on Operational Risk Exposures for FY 2001,* BLOOMBERG L. (June 7, 2002) (available by subscription at https://www.bloomberglaw.com/ [https://perma.cc/KX5G-48AH]).

82 *Cf.* Internal Ratings-Based Systems for Corporate Credit and Operational Risk Advanced Measurement Approaches for Regulatory Capital, 68 Fed. Reg. 45, 949 (Aug. 4, 2003) (discussing the significance of operational risk).

83 Malloy, *supra* note 4, at 95.

enterprises.[84] Consolidation and diversification took place in a markedly more globalized market environment.[85]

Fourth, the methodology tended to be insensitive to the individual experience and operational qualities of banks. The framework had one size to fit all banks subject to capital adequacy requirements.[86] Thus, greater reliance on standardized capital adequacy calculations—a tendency clearly exhibited by U.S. statutes—carried with it the danger that there would be less emphasis on individualized safety-and-soundness assessment of particular banks.[87]

Over the past two decades, the BIS Committee began working on amendments to the 1988 Guidelines in order to account for new globalized financial practices and to create a more flexible, risk-sensitive framework for determining minimum capital requirements.[88] In June 1999, the BIS issued a proposal that would significantly revise the capital adequacy accord, in two basic ways: by extensively refining the 1988 guidelines, and by providing a dramatic alternative approach.[89] The new approach had three basic principles: (i) international banks would be required to establish their own internal methods for assessing the relative risks of their assets, (ii) supervisory authorities would be expected to exercise greater oversight of these capital assessments, and (iii) greater transparency in banking operations would be required, *e.g.*, the creditworthiness of borrowing governments and corporations would be assessed by credit-rating agencies, and these ratings would be used by banks in pricing loans to such borrowers.[90] Financial institutions

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84 MALLOY, *supra* note 7, § 6.1.

85 *Id.* § 9.2.

86 This was particularly true of the U.S. application of the BIS framework. While the framework by its own terms applied only to international banks, U.S. statutes and implementing regulations applied the capital adequacy regime to *all* banks subject to federal regulation. *See* text and accompanying note, *supra* note 53 (discussing scope of U.S. capital adequacy rules).

87 *Cf., e.g.*, MALLOY, *supra* note 7, § 7.10 (questioning whether capital supervision is an appropriate way to monitor safety and soundness).

88 *See* Daniel Pruzin, *Basel Committee Sets Out Changes to Risk Calculations Under Capital Accord*, BLOOMBERG L. (Oct. 3, 2001) (available by subscription at https://www.bloomberglaw.com [https://perma.cc/B6EZ-3UR4]) (discussing BIS motivations for proposed Capital Accord); s*ee also* MALLOY, *supra* note 7 (citing BIS issuances concerning refinement of capital adequacy framework).

89 *See, e.g.*, Alan Cowell, *An International Banking Panel Proposes Ways to Limit Risk*, N.Y. TIMES, June 4, 1999, at C4, col. 2 (describing proposed revision).

90 *Id.* at C4, col. 4.

had until March 31, 2000 to respond to the proposed revisions, which the BIS anticipated would be effective no sooner than 2001.[91]

A revised version of the proposal was issued for comment in January 2001.[92] This version adopted a three-pronged approach to capital adequacy for international banks that were qualified to use it: capital adequacy requirements (largely revised from the 1988 guidelines);[93] increased supervision of bank capital maintenance policies;[94] and greater transparency through disclosure to the market, with resulting market discipline.[95] These elements were referred to as the three "pillars" of minimum capital requirements, the supervisory review process, and market discipline.[96]

The revised proposal was highly criticized by banking industry commentators,[97] mainly because of reporting requirements perceived as excessive, and the level of capital charges viewed as unnecessarily high. In addition, in Spring 2001, the annual report of the BIS Committee on Banking Supervision, reviewing the public disclosure practices of international banks, criticized the relative lack of disclosure in areas related to credit risk modeling and use of internal and external ratings by major banks.[98] This situation adversely implicated the proposed revision of the capital accord, since disclosure of information with respect to use of internal ratings is

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91 *Id.*

92 ACCORD, *supra* note 81.

93 *See id.* at 6–103 (discussing approaches to capital requirements).

94 *See id.* at 104–12 (discussing supervision).

95 *See id.* at 114–33 (discussing transparency and disclosure).

96 *See* Daniel Pruzin, *Capital Accord Draft Completion Delayed as Basel Committee Eyes New Revisions*, BLOOMBERG L. (June 26, 2001) (available by subscription at https://www.bloomberglaw.com [https://perma.cc/8ZUS-QU6T]) (noting industry opposition).

97 *Id.*

98 Daniel Pruzin, *Basel Committee Cites Mixed Results for Meeting Proposed Capital Accord*, BLOOMBERG L. (Apr. 24, 2001) (available by subscription at https://www.bloomberglaw.com [https://perma.cc/KRB5-HMT5]) [hereinafter Pruzin, *Basel Committee Cites Mixed Results*]. However, in a May 2002 report, the Basel Committee indicated that internationally active banks had modestly increased their public disclosure of such information during 2000. Daniel Pruzin, *Basel Committee Cites 'Modest' Improvement in Information Disclosures*, BLOOMBERG L. (May 16, 2002) (available by subscription at https://www.bloomberglaw.com [https://perma.cc/HW2E-S6LV]). Nevertheless, it did caution that most banks still failed to provide such information with respect to the use of credit derivatives and other sophisticated instruments subject to reporting requirements under the proposed accord. *Id.*

necessary for banks to qualify for the internal ratings-based approach proposed in "Pillar I" of the new accord.[99]

After much reconsideration, in April 2003, the Basel Committee asked for comment on its "Third Consultative Paper of the New Basel Capital Accord," and indicated its intention to finalize in the near future a Basel II Accord that would be implemented in 2007.[100] In August 2003, the British Bankers' Association and the London Investment Banking Association confirmed that they had requested a delay in Basel II until 2010 and expressed a desire that the Basel II rules be further revised to be "less prescriptive and more principles-based."[101] Towards the end of that month, Standard & Poor's ("S&P") Rating Service announced that it might downgrade banks if it disagreed with methods the banks used under Basel II to calculate capital requirements.[102] Although S&P expressed support for the Basel II effort to improve bank sensitivity to risk and risk assessment and measurement, "changes in the availability of credit arising from incentives created by the accord could have far-reaching effects on bank funding, the continued development of international capital markets, and the global economy."[103]

Following even more wrangling among policymakers of participating states,[104] in May 2004 the Committee announced that it had finally reached agreement on outstanding issues that had impeded the finalizing of the Basel II accord.[105] The Committee stated that

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99 Pruzin, *Basel Committee Cites Mixed Results*, *supra* note 98.

100 R. Christian Bruce, *Regulators Must Supply More Answers Before Basel Can Be Adopted, Shelby, Sarbanes Say*, BLOOMBERG L., (June 19, 2003) (available by subscription at https://www.bloomberglaw.com [https://perma.cc/A2GN-RUBW]).

101 Patrick Tracey & Karen Werner, *British Banking Groups Seek Delay in Basel II Capital Accord Until 2010*, BLOOMBERG L. (Aug. 11, 2003) (available by subscription at https://www.bloomberglaw.com [https://perma.cc/MWX6-QTW4]).

102 Richard Cowden, *S&P Report Says It Might Downgrade Some Banks Under Basel II Rules*, BLOOMBERG L. (Aug. 28, 2003) (available by subscription at https://www.bloomberglaw.com [https://perma.cc/DYJ4-EGWZ]).

103 *Id*. (quoting Barbara Ridpath, Managing Director and Chief Criteria Officer, Standard & Poor's Europe).

104 *See, e.g.*, Richard Cowden, *Regulators, Lawmakers, Industry Cautious as Basel II Accord Staggers to Finish Line*, BLOOMBERG L. (Apr. 26, 2004) (available by subscription at https://www.bloomberglaw.com [https://perma.cc/W6AW-4XSK]) (reporting on preference of U.S. banks, regulators, and lawmakers to delay Basel II implementation past 2006); Bruce, *supra* note 100 (reporting on congressional dissatisfaction with Basel II deliberations).

105 These issues included calibration of minimum capital requirements, the proposed

it would adhere to the proposed year-end 2006 target date for banks to adopt the more basic "standardized" and "foundation IRB" approaches for assessing minimum capital charges.[106] However, for banks adopting the most advanced IRB approaches—most, if not all, major internationally-active banks[107]—the Committee expected that a year-end 2007 target date was necessary to allow further impact analysis and parallel running of old and revised standards before full implementation.[108]

On June 26, 2004, the Committee approved the final version of the revised accord.[109] The Committee emphasized that it would continue to review the calibration of the accord prior to its implementation and adjust it as necessary to ensure that the new capital rules did not result in a sharp increase in overall minimum capital requirements.[110] As with the previous guidelines, the Committee expected that the revised accord would become the global standard for minimum capital requirements.[111] However, India and China, among other major developing countries, indicated that they did not intend to adopt the revised accord,[112] and U.S. regulators—including the

capital charge for operational risk, and the use of advanced internal ratings-based [IRB] systems for assessing bank capital charges. Daniel Pruzin, *Basel Committee Announces Deal on Key Remaining Accord Issues*, BLOOMBERG L. (May 12, 2004) (available by subscription at https://www.bloomberglaw.com [https://perma.cc/A74D-3HMS]).

106 *Id.* Competitive effects may be exhibited even during the transition period. *See* Richard Cowden, *Report Says Basel II Could Produce Significant Competitive Effects Soon*, BLOOMBERG L. (July 16, 2004) (available by subscription at https://www.bloomberglaw.com [https://perma.cc/LEE6-6AJU]) (reporting on July 2004 report issued by Federal Financial Analytics, Inc., suggesting non-U.S. banks adopting basic form of the revised capital standards, "standardized approach," may experience immediate competitive advantage over short term).

107 *See, e.g.*, Bank Holding Companies and Change in Bank Control, 12 C.F.R. pt. 225, App. A, § 1.b.(2) n.6 (2004) (defining an "internationally active banking organization" as a banking organization that on a year-end basis had total consolidated assets of $250 billion or more *or* total on-balance-sheet foreign exposure of $10 billion or more).

108 Pruzin, *supra* note 105.

109 BCBS, BASEL II: INTERNATIONAL CONVERGENCE OF CAPITAL MEASUREMENT AND CAPITAL STANDARDS: A REVISED FRAMEWORK (2004), https://www.bis.org/publ/bcbs107.pdf [https://perma.cc/Q3WM-P9WR].

110 Daniel Pruzin, *Basel Committee Approves 'Final' Version of Capital Accord; Criteria Could Still 'Evolve'*, BLOOMBERG L. (June 29, 2004) (available by subscription at https://www.bloomberglaw.com [https://perma.cc/952W-YTG6]).

111 *Id.*

112 *Id.* However, in April 2006, the head of the China Banking Regulatory Commission ("CBRC") stated that China would adopt Basel II standards within four to six years

Securities and Exchange Commission ("SEC") as well as the banking regulators—decided that it would only be required for the twenty or so largest internationally active U.S. banks.[113] Nevertheless, according to the Secretary-General of the Basel Committee, Basel II would still make financial markets healthier by giving accountants, investors, and other interested parties more information on which to base critical decisions.[114]

But implementation of Basel II encountered significant difficulties. In June 2005, George French, the Federal Deposit Insurance Corporation ("FDIC") Deputy Director for Policy and Examination Oversight, suggested that differences between U.S. and European procedures for bringing Basel II into effect could inhibit multilateral cooperation in the effort to revise global capital standards.[115] There was also substantive concern whether implementation of Basel II,

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for domestic banks with substantial numbers of overseas branches. Kathleen E. McLaughlin, *CBRC Chair Says China Will Adopt Basel II Standards Starting in 2010*, BLOOMBERG L. (Apr. 13, 2006) (available by subscription at https://www.bloomberglaw.com [https://perma.cc/CKQ3-73WJ]). With the subsequent switch to Basel III arrangements, discussed *infra*, the CBRC director-general of policy research and statistics expressed support for Basel III as "an important step in terms of building a robust global financial architecture.'' Joyce E. Cutler, *Asian Countries Ready for Basel III, Want Consideration of Local Realities*, BLOOMBERG L. (Sept. 12, 2011) (available by subscription at https://www.bloomberglaw.com [https://perma.cc/2WPP-SY78]) (quoting CBRC director-general Liu during Asian banking conference in San Francisco). Reportedly, the CBRC currently is revising its regulations so Basel III implementation can begin by some time in 2012. *Id*. Likewise, in December 2011, the government of the Hong Kong Special Administrative Region ("SAR") announced that it would introduce Banking Bill 2011, an amendment to its Banking Ordinance to initiate the process of adopting the Basel III framework. *See* Michael Standaert, *Hong Kong to Amend Banking Ordinance to Implement Basel III Conventions*, BLOOMBERG L. (Dec. 12, 2011) (available by subscription at https://www.bloomberglaw.com [https://perma.cc/PH6B-7CSA]) (reporting on Hong Kong SAR proposed adoption of Basel III standards).

113 *Five Federal Agencies Announce Plans to Implement Basel II over Four-Year Period*, BLOOMBERG L. (June 29, 2004) (available by subscription at https://www.bloomberglaw.com [https://perma.cc/4U7W-TUYN]).

114 Ryozo Himino, *Basel II—Towards a New Common Language*, BIS Q. REV. (Sept. 6, 2004), http://www.bis.org/press/p040906.htm [https://perma.cc/WR85-TEFD]. As an example, Secretary-General Himino argued that Basel II will mean more transparency, allowing investors to know, for example, whether the bank's assets are risk-free cash or high-risk securities. *Id*.

115 *See* R. Christian Bruce, *FDIC Official Cites Basel II 'Disconnect' Between U.S., European Bank Regulators*, BLOOMBERG L. (June 28, 2005) (available by subscription https://www.bloomberglaw.com [https://perma.cc/G4VQ-BMQJ]) (reporting on France's remarks). U.S. supervisors are using a regulatory process to implement Basel II, whereas European implementation is expected to be affected through legislative amendments. *Id*.

which would be fully applicable only for the largest U.S. internationally active banks,[116] might result in significant capital reductions for those banks in the aggregate.[117] This could stratify bank regulation between the largest U.S. banks and other financial institutions.

Preparations for implementation of Basel II continued nevertheless. The comment period for the proposed implementing rules ended on March 26, 2007.[118] Although the agencies had agreed jointly to issue the September 2006 proposed rules for comment, clear differences among the FDIC, the Office of the Comptroller of the Currency ("OCC"), the Federal Reserve System ("the Fed"), and the Office of Thrift Supervision ("OTS") surfaced over what the final version of the Basel II rules should look like.[119] Finally, in July 2007 the regulators announced that they had reached a compromise agreement on a final rule for U.S. implementation of Basel II in early 2008.[120]

In December 2007, the four regulators jointly published final rules implementing Basel II for the largest, internationally active U.S. banks.[121] The final rules were effective on April 1, 2008.[122] While U.S. banking institutions were expected to begin a preliminary phase of implementation early in 2008, compliance with Basel

116 Ten to fifteen U.S. banks are likely to be required to adopt Basel II, with perhaps another fifteen or so being permitted to move to the Basel II system. The vast majority of U.S. banks are expected to continue to operate subject to Basel I. *Id*.

117 *Id*.

118 *See, e.g.*, Michael Bologna, *Federal Reserve Working Quickly to Implement Basel II Final Rules*, BLOOMBERG L. (May 22, 2007) (available by subscription at https://www.bloomberglaw.com [https://perma.cc/K8KL-X8JP]).

119 *See, e.g., id.* (discussing Fed's concerns that review of Basel II proposal was falling increasingly behind "in terms of industry practice, which continues to evolve;" suggesting that Basel II proposal was "a very dynamic process" subject to continuing revision).

120 R. Christian Bruce, *Regulators Reach Agreement on Basel II, Clearing Path for 2008 U.S. Implementation*, BLOOMBERG L. (July 23, 2007) (available by subscription at https://www.bloomberglaw.com [https://perma.cc/Y8NL-HPK2]).

121 Risk-Based Capital Standards, 72 Fed. Reg. 69,288 (Dec. 7, 2007) (codified at 12 C.F.R. pts. 3 (OCC rules), 208, 225 (Fed rules), 325 (FDIC rules), 559–560, 563, 567 (OTS rules)), *corrected*, 79 Fed. Reg. 51,471 (Aug. 29, 2014) (codified at 12 C.F.R. §§ 3.121, 3.202) (technical corrections). For simplicity, the final rule uses the term "bank" to include banks, savings associations, and bank holding companies ("BHCs"). Risk-Based Capital Standards, 72 Fed. Reg. 69,288 n.1 (Dec. 7, 2007). The terms "bank holding company" and BHC do not include savings and loan holding companies regulated by the OTS. *Id*.

122 Risk-Based Capital Standards, 72 Fed. Reg. 69,288 (Dec. 7, 2007).

II was not required until January 1, 2009, when the new standards would begin to be phased in over a three-year period.[123] It was anticipated that only twenty-five or so of U.S. banking institutions would be required to adopt Basel II, with another small group of relatively large U.S. banking institutions having the option to do the same.[124] The overwhelming majority of U.S. banking institutions would be required either to continue to apply the 1988 Basel I standards, or to adopt the new and more risk-sensitive version of the original standards, known as Basel IA.[125]

Unfortunately, at this point the 2008 collapse of capital markets intervened.[126] At least one reason that the current economic and financial crisis became so severe was that the financial services sector in many countries accumulated excessive on- and off-balance sheet leverage, accompanied by a gradual erosion of the level and quality of their capital base.[127] Despite the capital adequacy requirements, the international banking system was simply not capable of absorbing the systemic losses that bled into it.[128] In the aftermath of the crisis, the Basel Committee announced in July 2009 that it had agreed in principle to three significant sets of changes in the Basel II capital accord.[129] First, Pillar 1 capital requirements would be significantly revised; the Committee would require a leverage ratio of core capital to assets as a backup measure to the Basel II capital-

123 R. Christian Bruce, *Fed's Governors, Eyeing Credit Turmoil, Welcome New Capital Rules Under Basel II*, BLOOMBERG L. (Nov. 5, 2007) (available by subscription at https://www.bloomberglaw.com [https://perma.cc/3ADC-YL5R]).

124 *Id*.

125 *Id*.

126 On the origins of the 2008 crisis, see MALLOY, ANATOMY OF A MELTDOWN, *supra* note 37.

127 *See, e.g.*, Frederic S. Mishkin, Member, Bd. of Governors of Fed. Res. Sys., Speech on "Leveraged Losses: Lessons from the Mortgage Meltdown" at the U.S. Monetary Policy Forum, New York, New York (Feb. 29, 2008) (transcript available at http://www.federalreserve.gov/newsevents/speech/mishkin20080229a.htm [https://perma.cc/A7TG-7K7K]) (discussing the role of leverage).

128 MICHAEL P. MALLOY, *The Subprime Mortgage Crisis: An International and Regional Threat in Need of a Solution*, *in* NEW CHALLENGES OF THE LAW IN A PERMEABLE WORLD 9 (David A. Frenkel & Carsten Gerner-Beuerle eds., 2009).

129 *See* Press Release, BCBS, Basel II Capital Framework Enhancements Announced by the Basel Committee (July 13, 2009), http://www.bis.org/press/p090713.htm [https://perma.cc/6VZV-F28N] (setting forth committee statements on revisions); *see also* Daniel Pruzin, *Basel Committee Announces Changes to Supervisory Pillar of Capital Accord*, BLOOMBERG L. (July 14, 2009) (available by subscription at https://www.bloomberglaw.com [https://perma.cc/7HWB-7F3N]).

assets ratio.[130] In addition, banks would be expected to build up capital above the required ratio as a reserve against future systemic crises.[131] Finally, banks would be required to improve the quality of capital maintained in these reserves, possibly by increasing the percentage of core capital required in the calculation of the capital to assets ratio.[132] The actual calibration of the leverage ratio and of the systemic reserve was deferred until later in 2010.[133] Banks would be expected to comply with the newly revised requirements by December 31, 2010, with Basel I capital requirements remaining in place in the interim.[134] The Committee also introduced higher risk weights for securitization exposures such as collateralized debt obligations[135] of asset-backed securities—subprime mortgage-related investments—to reflect the higher risk inherent in such products, and it raised the credit conversion factor for short-term liquidity facilities with respect to off-balance sheet conduits.[136]

Furthermore, the Committee planned to issue supplemental

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130 Committee participants such as the United States, Canada, and Switzerland have already introduced such leverage ratios. In the case of Switzerland, for example, the two largest banks, UBS and Credit Suisse, are required to maintain a minimum capital-core assets ratio of three percent for the consolidated group and four percent for the operating bank. Pruzin, *supra* note 129.

131 *Id.*

132 *Id.*

133 There are some indications that the committee would use the Canadian leverage ratio as a model; it includes on-balance sheet assets as well as off-balance sheet assets (including derivatives) in the leverage ratio. *Id*. By August 2012, the Canadian Government moved closer to reconciling its current Capital Adequacy Requirements Guidelines with the new Basel III reforms. *Draft New Capital Adequacy Guideline Meets Basel III Standard, Canadian Regulator Says*, BLOOMBERG L. (Aug. 10, 2012) (available by subscription at https://www.bloomberglaw.com [https://perma.cc/TW7G-S4JR]) (reporting on draft Canadian capital adequacy guidelines).

134 Pruzin, *supra* note 129.

135 In contrast, however, it now appears that new issuances of collateralized loan obligations ("CLOs") are on the rise, although as yet these have not resulted in sustained market growth. Stephen Joyce, *Revival of Collateralized Loan Obligation Market Seen Slowed by EU, U.S. Regulations*, BLOOMBERG L. (Dec. 4, 2012) (available by subscription at https://www.bloomberglaw.com [https://perma.cc/7TAU-FP48]). A CLO is a financial instrument that securitizes pieces of large corporate loans, through the medium of a special purpose vehicle, for sale to eligible investors. The CLO issuer creates different tranches of instruments, with senior tranches, typically rated AAA to BB and pricing based on the priority with which each receives payments of principal and interest from the pool of assets. Before the financial crisis, CLOs were popular with investors, with new issuances in 2007 reaching almost $95 billion. *Id*.

136 Pruzin, *supra* note 129.

guidance under Pillar 2 of Basel II, governing enhanced supervision of banks, to address the flaws in risk management revealed by the financial crisis.[137] In particular, the supplemental guidance was expected to raise the standards for enterprise-wide governance and risk management of internationally active banks, to improve the identification of off-balance sheet risks and the management of risk concentrations within banks, and to provide incentives for banks to manage long-term risk and returns better.[138] The Committee expected these changes to be implemented immediately.[139]

Finally, Pillar 3, establishing disclosure requirements, would be revised to strengthen disclosure requirements for securitizations, off-balance sheet exposures and trading activities.[140] Banks would have until December 31, 2010, to implement the revised Pillar 3 requirements.[141]

In December 2009, the Committee fleshed out the agreement in principle[142] by issuing two proposals to further revise the Basel Accord to strengthen capital requirements[143] and to improve risk management of liquidity.[144] However, the Committee acknowledged that a fully calibrated set of revised standards would only be phased in over a period of years.[145] Essentially, Basel II was losing

137 Joyce, *supra* note 135.

138 *Id.*

139 *Id.*

140 *Id*.

141 Pruzin, *supra* note 129.

142 BCBS, STRENGTHENING THE RESILIENCE OF THE BANKING SECTOR 65 (2009), https://www.bis.org/publ/bcbs164.pdf [https://perma.cc/LDJ5-U6ZR]; BCBS, INTERNATIONAL FRAMEWORK FOR LIQUIDITY RISK MEASUREMENT, STANDARDS AND MONITORING 5–19 (2009), https://www.bis.org/publ/bcbs165.pdf [https://perma.cc/3G7Q-3D9R]. For the U.S. Government position encouraging Basel II revisions for higher regulatory capital and liquidity standards by the end of 2010, see Press Release, U.S. Dep't of Treasury, Stronger Capital and Liquidity Standards for Banking Firms (Sept. 3, 2009), https://www.treasury.gov/press-center/press-releases/Pages/tg274.aspx [https://perma.cc/LWE5-FMD3]. *See also* R. Christian Bruce, *Treasury Department Eyes Global Accord on Bank Regulatory Capital by End of 2010*, BLOOMBERG L. (Sept. 4, 2009) (available by subscription at www.bloomberglaw.com [https://perma.cc/V84F-GSLY]).

143 *See* BCBS, , BASEL III DEFINITION OF CAPITAL - FREQUENTLY ASKED QUESTIONS 2–8 (2011), https://www.bis.org/bcbs/publ/d417.pdf [https://perma.cc/B9W3-M374] (discussing disclosure requirements).

144 *Id.*

145 Daniel Pruzin, *Basel Committee Unveils Proposals for Strengthening Global Financial System*, BLOOMBERG L. (Dec. 18, 2009) (available by subscription at https://www.bloomberglaw.com [https://perma.cc/4LBJ-4A9F]).

momentum.[146]

B. Basel III

In effect, the Committee was already headed towards a "Basel III" arrangement.[147] The problem, however, was that the added capital costs of markedly stronger liquidity requirements could well be prohibitive for most banks.[148] According to a December 2010 study by the Committee for European Banking Supervisors,[149] large, internationally active EU-based banks would have difficulty complying with the proposed Basel III Tier 1 capital ratio of seven percent.[150] Assuming full implementation of the final Basel III requirements, based on data as of year-end 2009,

> [t]he Tier 1 capital ratios of Group 1 banks [i.e., banks with Tier 1 capital in excess of € 3 billion] would on average decline from 10.3% to 5.6%, while total capital ratios would decrease from 14.0% to 8.1%. The reduction in other capital ratios is also less pronounced for Group 2 banks [i.e., all other banks]. Tier 1 capital ratios would decrease from 10.3% to 7.6% and total capital ratios

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146 *See* Daniel Pruzin, *Basel Committee Cites Continued Progress on Implementation of Basel Capital Rules*, BLOOMBERG L. (Aug. 28, 2013) (available by subscription at https://www.bloomberglaw.com [https://perma.cc/6KAC-2E64]) (discussing Basel committee report on implementation of capital rules). However, as of August 2013, 22 Basel Committee member states had fully implemented the so-called Basel 2.5, the 2009 agreement to enhance the measurement of risks related to securitization and trading book exposures, while Argentina, Indonesia, Mexico, Russia, and the United States had either partially adopted or were at the proposal stage with respect to Basel 2.5. *Id*.

147 *Cf.* MALLOY, *supra* note 5, § 7.03[C][4][b] (discussing extensive proposed revisions to Basel II). *See generally* Gregory J. Lyons & Chan E. Casey, *Basel III–An Initial Piece of the Global Puzzle*, 5 DEBEVOISE & PLIMPTON FIN. INSTS. REP. 8 (2011) (discussing Basel III arrangements).

148 *See* Daniel Pruzin, *Research Group Says Banks Would 'Struggle' to Meet Liquidity Standards of Basel III Draft*, BLOOMBERG L. (May 10, 2010) (available by subscription at https://www.bloomberglaw.com [https://perma.cc/858Y-FKDH]) (reporting on analysts' concerns about consequences of "Basel III" liquidity proposals).

149 COMM. OF EUR. BANKING SUPERVISORS, RESULTS OF THE COMPREHENSIVE QUANTITATIVE IMPACT STUDY 3 (2010), https://eba.europa.eu/sites/default/documents/files/documents/10180/16151/52fc33da-4a4d-422a-858b-fa29a896182d/EU-QIS-report-2.pdf [https://perma.cc/DSF8-EF8Z].

150 In September 2012, the European Banking Authority reported that among the 44 largest EU banks there was still a capital shortfall totaling $256 billion as measured against a 7 percent core tier one capital standard. Joe Kirwin, *EU Banks Face Basel III Shortfall of $256 Billion, Bank Authority Says*, BLOOMBERG L. (Sept. 28, 2012) (available by subscription at https://www.bloomberglaw.com [https://perma.cc/C5WU-RXPT]).

would decline from 13.1% to 10.3%.[151]

Furthermore, in light of the fact that the U.S. regulators never fully implemented Basel II, the very real possibility that they might abandon Basel III, in whole or in part, continued to be a source of serious concern among European regulators in particular.[152] In contrast, implementation of Basel III has come to be viewed as a critical component of economic and fiscal recovery within Europe,[153] and especially within the Euro Zone.[154] The European Union has continued to move forward with implementation of Basel III.[155] In

151 COMM. OF EUR. BANKING SUPERVISORS, *supra* note 149, at 3.

152 *See, e.g.*, Aaron Lorenzo, *European Officials Worry U.S. Regulators Might Not Heed New Basel Standards*, BLOOMBERG L. (Jun. 9, 2010) (available by subscription at https://www.bloomberglaw.com [https://perma.cc/Q5W4-4ZUF]) (reporting on European concerns over possible failure of capital harmonization efforts).

153 *Cf.* Jeffery Atik, *EU Implementation of Basel III in the Shadow of Euro Crisis*, 33 REV. BANKING & FIN. L. 283, 328–30 (2013) (demonstrating that European sovereign debt crisis, not the 2007-2008 financial meltdown, is the focus of recent EU regulatory policy, with resulting attenuation of strict conformity to Basel III).

154 *See* Steven T. Voigt, *The General Welfare Clause: An Exploration of Original Intent and Constitutional Limits Pertaining to the Rapidly Expanding Federal Budget*, 43 CREIGHTON L. REV. 543, 561 n.75 (2010).

> The euro-zone [*sic*] is a currency union of 16 European states [17, since 1 January 2011] which have adopted the euro as their sole legal tender. The eurozone [*sic*] currently consists of Austria, Belgium, Cyprus, [since 1 January 2011, Estonia,] Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Malta, the Netherlands, Portugal, Slovakia, Slovenia, and Spain.

Id. Latvia, whose austerity program appears to have been a success, was approved in June 2013 to become the 18th member of the Euro Zone in 2014. *See* Joe Kirwin, *Latvia Welcomed into Eurozone, Hailed as Rare Austerity Success Story*, BLOOMBERG L. (June 6, 2013) (available by subscription at https://www.bloomberglaw.com [https://perma.cc/P2RW-D9KU]). More generically, the Euro itself, "is also used in Andorra, Monaco, San Marino, the Vatican and some French overseas territories." Michael P. Malloy, *Negotiating in a Ditch: Institutional Implications of the Sovereign Debt Crisis*, 28 CONN. J. INT'L L. 1, 3 n.1 (2012). It is also the official currency in Montenegro and Kosovo. *Id.* A December 2010 OECD report on the Euro Zone recommended that EU economic authorities should speed up implementation of the Basel III capital accord as well as enhancing financial supervision, especially in the area of risk diversification. *See generally* ORG. FOR ECON. CO-OPERATION & DEV. ("OECD"), OECD ECONOMIC SURVEYS: EURO AREA 2010 (2010), *available at* https://www.oecd-ilibrary.org/economics/oecd-economic-surveys-euro-area-2010_eco_surveys-euz-2010-en [https://perma.cc/3E7H-Y8P4]; Rick Mitchell, *OECD Study Says EU Should Consider Faster Implementation of Basel III Rules*, BLOOMBERG L. (Dec. 14, 2010) (available by subscription at https://www.bloomberglaw.com [https://perma.cc/F2BNJXSQ]) (reporting on OECD recommendations).

155 However, the aftermath of the 2008 financial crisis dramatically affected other EU initiatives. *See, e.g.*, Diana Gregg, *Banking Union Some Way off, Almunia Tells*

October 2010, the European Commission initiated a consultation process[156] for new rules requiring financial institutions to build "countercyclical" capital buffers during times of robust economic growth. In accordance with Basel III, the new rules contemplated higher capital requirements during high-growth periods and lower capital requirements during economic downturns.[157]

The Committee issued a final version of the new Basel III capital rules on December 16, 2010.[158] When fully effective, the new rules would require internationally active banks to increase the amount of high-quality, low-risk capital in the form of common equity more than three-fold, from a current minimum level of 2 percent of risk-weighted assets to 4.5 percent by 2015, with an additional 2.5 percent "capital conservation buffer" to be phased in by January 2019.[159] Overall minimum Tier 1 capital (*i.e.*, common equity and qualifying low-risk financial instruments) would increase from a present minimum of 4 percent to 4.5 percent by January 2013 and 6 percent by 2015.[160]

Recovery from the 2008 collapse remains elusive and incomplete, and this uncertainty has impeded confidence and consensus in Basel III.[161] In March 2016, the Basel Committee proposed to

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Washington Think-Tank, BLOOMBERG L. (Sept. 26, 2013) (available by subscription at https://www.bloomberglaw.com [https://perma.cc/5WLV-UDQY]) (discussing remarks by EU vice president and commissioner for competition concerning delays in bank regulatory integration as result of financial crisis).

156 *Consultation on Countercyclical Buffers*, EUR. COMM'N ON BANKING & FIN., https://ec.europa.eu/finance/consultations/2010/capital-buffer/index_en.htm [https://perma.cc/9BUS-6VDS]; *see* Joe Kirwin, *EC Begins Adoption of Basel Standards for Bank Countercyclical Capital Buffers*, BLOOMBERG L. (Oct. 25, 2010) (available by subscription at https://www.bloomberglaw.com [https://perma.cc/Q6QE-E3S4]) (reporting on consultation with respect to countercyclical capital buffers).

157 Kirwin, *supra* note 156.

158 *See* BCBS, BASEL III: INTERNATIONAL FRAMEWORK FOR LIQUIDITY RISK MEASUREMENT, STANDARDS AND MONITORING 3 (2010), https://www.bis.org/publ/bcbs188.pdf [https://perma.cc/ZU7N-N4AE] (providing "rules text" of macro and microprudential standards); *see also* Daniel Pruzin, *Basel Panel Issues Final 'Basel III' Package; Version Contains New Liquidity Rule Details*, BLOOMBERG L. (Dec. 17, 2010) (available by subscription at https://www.bloomberglaw.com [https://perma.cc/URT7-Y4LZ]) (reporting on issuance of package of releases). For a useful discussion of the LCR, see Andrew W. Hartlage, *The Basel III Liquidity Coverage Ratio and Financial Stability*, 111 MICH. L. REV. 453, 462–70 (2012).

159 Pruzin, *supra* note 158.

160 *Id*.

161 *Cf., e.g.*, BANK OF ENG., FINANCIAL STABILITY REPORT 52 (2008),

remove the option for banks to use their own IRB models to determine their capital assets ratio,[162] which would force them to use a standardized method set by their respective regulators. The proposal was intended to simplify the capital adequacy rubric and to reduce wide variations in supervisory results.[163] The plan also envisioned a floor to limit how far risk assessments using the models that would still be allowed—for assets such as mortgages and small-business loans—can diverge from those obtained with the standardized approach.[164] Thus, difficulties that emerged over post-crisis capital rules set stricter standards for how lenders estimate the riskiness of their assets, dubbed by the global banking industry as "Basel IV."[165] Estimates suggest that the new accounting framework could reduce the common equity Tier 1 ratio for some lenders by 3.9 percentage points, to 9.5 percent in the aggregate.[166]

C. The Role of Capital as a Regulatory Tool

One fundamental question remains unresolved: why use capital as the basic measuring tool of safety and soundness in banking supervision? In traditional corporate law terms, capital serves at least four distinct roles. First, capital is the source of the primary (or, at least, the most significant) operational financial resources for the corporate enterprise.[167] Second, it is the marker for the competing property interests in the enterprise, indicating the ultimate (*i.e.*, liquidational) property rights of various classes of investors.[168] Third, capital serves as a marker for associational rights and obligations,

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https://www.bankofengland.co.uk/-/media/boe/files/financial-stability-report/2008/october-2008.pdf?la=en&hash=DA2C19274CA14E7F6CAE953CEF3FD046B553265C [https://perma.cc/K6N3-8XT9] (calling for "fundamental overhaul" of standards for systemic risk).

162 Silla Brush & John Glover, *Banks' Leeway on Credit Risk Narrows as Basel Tightens Rules*, BLOOMBERG L. (Mar. 25, 2016) (available by subscription at www.bloomberglaw.com [https://perma.cc/FJF2-V74T]).

163 *Id*.

164 *Id*.

165 *Id*.

166 *Id*.

167 *See generally* U.S. DEP'T. OF TREASURY, MODERNIZING THE FINANCIAL SYSTEM: RECOMMENDATIONS FOR SAFER, MORE COMPETITIVE BANKS (1991), https://catalog.hathitrust.org/Record/002480222 [https://perma.cc/9K8Z-XXZJ], *reprinted in* FED. BANKING L. REP. (CCH) ¶ 88,367 (Feb. 5, 1991) (discussing roles of capital in operation of a bank).

168 *Cf., e.g.*, 8 Del. Code Ann. § 151(a) (2020) (providing for rights of stockholders).

indicating, for example, the relative voting rights of different classes of investors.[169] Fourth, capital is the primary measure or precondition of insolvency.[170]

The problem is that banking enterprises tend to be atypical and asymmetrical with respect to the corporate roles of capital.[171] This is particularly true of the first and fourth roles of capital identified above. On the other hand, in sharp contrast with the pattern found in most modern general business corporation statutes, banking statutes add an additional role for capital—that of gatekeeper into the industry.[172] In this sense, minimum capital requirements and rules about continuing capital maintenance, long abandoned as formal requirements for incorporation under general business corporation statutes, continue to hold sway in the regulated industry of banking.[173] This fifth role may help to explain why in both national banking statutes and in the BIS guidelines and proposed accord, capital is treated as a central focus of supervisory policy.[174] Is this emphasis warranted as a matter of fact?

Early in the last century, in *Texas & Pacific Ry. v. Pottorff*,[175] Justice Brandeis observed: "The amount of the deposits is commonly accepted as a measure of the bank's success; and increase of deposits as evidence of increased prosperity."[176] Thus, banks are exceptionally adept at using other people's money, rather than their own capital, as the primary source of operational resources. It is the bank deposit, a form of debt arrangement, that generates the primary

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169 *See, e.g., id.* § 212(a) (providing rules with respect to voting rights of stockholders).

170 *Cf.* Production Resources Group, L.L.C. v. NCT Group, Inc., 863 A.2d 772 (Del. Ch. 2004) (holding that for purposes of receivership action, creditor sufficiently pled that corporation was insolvent).

171 *See* MALLOY, *supra* note 7, at 312 (noting that "[e]ven banks that fully comply with capital requirements are still highly leveraged, far beyond the levels of viable general business corporations").

172 *See, e.g.*, 12 C.F.R. § 5.20(f)(2)(i)(C) (2020) (for national bank charter, requiring "capital that is sufficient to support the projected volume and type of business").

173 *Compare*, *e.g.*, 8 Del. Code Ann. § 102 (omitting any requirement of minimum capital as condition of incorporation), *with* 12 C.F.R. § 5.20(f)(2)(i)(C) (requiring sufficient capital for national bank charter).

174 *See* MALLOY, *supra* note 7, at 282 (noting increased attention of regulators to capital supervision).

175 Tex. & Pac. Ry. v. Pottorff, 291 U.S. 245 (1934), *amended sub nom.* Tex. & Pac. Ry. v. First Nat'l Bank of El Paso, 291 U.S. 649 (1934).

176 *Pottorff*, 291 U.S. at 259.

bank assets—loans, investments and the like—and not a bank's capital.[177] In fact, banks are among the most highly leveraged of commercial enterprises.[178]

Of course, it may be argued that supervisory attention to capital requirements imposes market discipline on banks, and that this discipline will significantly supplement safety and soundness in banking.[179] This argument remains largely undemonstrated in empirical terms.[180] Given the highly leveraged condition of banks, it is likely that the market would in most instances exercise relatively trivial disciplinary pressure.[181] Furthermore, the capital market is the wrong market exercising the discipline; depositors, the major "investors" in these enterprises, tend to refrain from exercising discipline until it is too late.[182]

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177 MALLOY, *supra* note 2, at 4.

178 MALLOY, *supra* note 7, at 312.

179 *Cf. id.* at 294 (discussing market discipline).

180 *See generally* Helen A. Garten, *Still Banking on the Market: A Comment on the Failure of Market Discipline*, 5 YALE J. REG. 241 (1988) (criticizing market discipline arguments).

181 *Id.*

182 Some commentators have suggested that complete deregulation—and governance by market forces—represent the correct approach to bank regulatory policy in this regard. *See generally, e.g.*, Jonathan R. Macey & Elizabeth H. Garrett, *Market Discipline by Depositors: A Summary of the Theoretical and Empirical Arguments*, 5 YALE J. REG. 215 (1988) (arguing for increased reliance on market discipline by depositors). Market discipline presupposes that investors (and quasi-investors like depositors) can—and would—influence the choice of risk-generating activities of banks by their investment decisions. The assessment of the expected returned and potential investment risk by prospective or current investors might affect an institution's decisions by increasing the expected return offered (thus increasing the cost of relatively risky activities), or by decreasing the potential risk. There are at least two problems with this approach, however. First, as an empirical matter, depositors do not generally contract with depository institutions with the mindset or motivations of investors—nor is it clear that they should. *See generally* Helen A. Garten, *Banking on the Market: Relying on Depositors to Control Bank Risks*, 4 YALE J. REG. 129 (1986) (arguing that market discipline approach to bank regulation is unlikely to work in practice, given behavior of depositors); Garten, *supra* note 180 (criticizing market discipline arguments of Macey & Garrett). *See also* Helen A. Garten, *Regulatory Growing Pains: A Perspective on Bank Regulation in a Deregulatory Age*, 57 FORDHAM L. REV. 501, 558–64 (1989) [hereinafter Garten, *Growing Pains*] (discussing increased attention to "market discipline" approach to bank regulation). Second, public disclosure is *already* one instrument of regulation, and its proper role is open to question. *See generally* Michael P. Malloy, *Public Disclosure as a Tool of Federal Bank Regulation*, 9 ANN. REV. BANKING L. 229 (1990) (discussing and criticizing current uses of public disclosure in bank regulation). Indeed, the use of public disclosure in banking regulation has created additional ambiguity in the regulatory system, because the system is still essentially committed to a

Capital requirements might serve as a "tripwire" to alert bank and regulator alike to serious problems in a bank's operations. This argument similarly remains undemonstrated as an empirical matter.[183] Even if true, this is at most a post hoc alarm system, particularly when speaking of operational risk. Conceivably, additional market-sensitive tripwires would make more sense, possibly the oversight of market performance of subordinated debt—another major component of a bank's capital structure. However, the volatility of that market may make the tripwire very accurate but untimely.

III. Implications for International Law

A. General Sources of International Law

It is a commonplace notion that binding legal principles in public international law derive from a specific range of recognized sources.[184] The classic source is customary principles, derived from the common practice of states undertaken because of the perceived binding nature of the practice (*opinio juris*).[185] The second source is treaty law, legal principles derived from conventional practice.[186] A third, more elusive source is the body of general principles of law recognized by civilized states.[187] A fourth and final source, much beloved of academics, consists of the writings of recognized publicists.[188] It would be very difficult to find a place for the issuances and undertakings of the BIS in this array of sources.

confidential approach to supervision and enforcement. *See, e.g.*, Alfred Dennis Mathewson, *From Confidential Supervision to Market Discipline: The Role of Disclosure in the Regulation of Commercial Banks*, 11 J. CORP. L. 139, 146–50 (1986) (discussing development of "confidential supervision" as basic principle of federal bank regulation).

183 *Cf.* Garten, *Growing Pains*, *supra* note 182 at 550–51, 558–64 (noting disconnect between regulators' efforts and bank managers and shareholders responses).

184 *See, e.g.*, Statute of the International Court of Justice, art. 38, ¶ 1, Apr. 8, 1946, 33 U.S.T. 993 (identifying sources of law).

185 For a useful example of the establishment of a principle of customary international law, see North Sea Continental Shelf Cases (Ger. v. Den.; Ger. v. Neth.), 1969 I.C.J. Rep. 3 (Feb. 20, 1969).

186 Statute of the International Court of Justice, *supra* note 184, art. 38, ¶ 1.

187 *Id.*

188 *Id.*

B. The Legal Character of BIS Issuances

The BIS itself has consistently taken the position that the issuances of the Basel Committee are not sources of law.[189] Thus, it states on its website:

> The Basel Committee's approach to policy development relies on the coordinated work of its various working groups and task forces, a wide and open consultation process, and cooperation with international institutions. The Committee also strives to review the implementation of its standards in order to contribute to a level playing field among internationally active banks . . . .
>
> . . . Since the Committee does not possess any formal supranational authority, its decisions do not have legal force. The Committee, however, expects its members to implement standards in a full, timely and consistent manner.[190]

This position is reflected in the specific language of BIS issuances, particularly and most emphatically in the Basel Concordat. The Concordat is not, by its own terms, a binding international treaty or agreement; it is at best a statement of principles.[191] The Concordat purports to set forth the optimal operating principles endorsed by the members of the Committee.[192] Post-Concordat issuances of the BIS with respect to supervision of multinational banking enterprises, such as the April 1990 Supplement to the Concordat or the June 1992 Report On Minimum Standards, do not affect the character or basic framework established of the Concordat in this regard.[193]

While the principles identified in the 1992 Report are considered "standards," they are not, on their own explicit terms, binding on states.[194] Nevertheless, the Report also makes it clear that BIS

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189 *See, e.g.*, *Basel Committee Charter*, BIS, https://www.bis.org/bcbs/charter.htm [https://perma.cc/C6UM-F5ES] (last updated June 5, 2018) (providing that § I.3 states "The BCBS does not possess any formal supranational authority. Its decisions do not have legal force").

190 *Policy Development and Implementation Review*, BIS, https://www.bis.org/bcbs/review_process.htm [https://perma.cc/ENB6-VSPD] (last updated Apr. 14, 2018) [hereinafter *Policy Development*].

191 *See* PRINCIPLES FOR SUPERVISION, *supra* note 20, § 1 ("This report sets out *certain principles* which the Committee *believes should govern* the supervision of banks' foreign establishments by parent and host authorities.") (emphasis added).

192 *Id.*

193 *Policy Development*, *supra* note 190.

194 MINIMUM STANDARDS, *supra* note 25, at 76-80 ("[C]ertain of these principles [of

participating states are expected to implement the standards, and other states are encouraged to do so—the fourth "standard" seems to establish a right in participating states to exclude banking enterprises from states that do not endorse the standards.[195] Indeed, in U.S. practice the fourth standard has been implemented as a statutory expectation and requirement; a non-U.S.-based banking enterprise applying for entry will be subject to comprehensive supervision by its home state as a condition of entry into the U.S. market.[196]

While the BIS has been consistently careful to refrain from asserting source-of-law status for the issuances of the Basel Committee, products like the 1988 Capital Accord I do not express themselves in mere precatory language, but in prescriptive terms. More importantly, states have endorsed the specific principles of the Accord as legally binding features of their national regulatory systems, and the states—and affected private sectors—have treated the further development of the Accord as legally significant.[197] One might argue that the administrative process of rule-creation performed by the Basel Committee is itself an emerging source of international regulatory law, intended to be implemented and enforced by adoption in individual national regulatory systems. It remains, then, to examine the behavior of states and other interested parties in this regard.

C. *Behavior of States*

Recognition of the untraditional character of this process of rule-creation should not be blunted by a narrow allegiance to traditional categories of sources of law under public international law. Contemporary behavior of states with respect to bank regulatory

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the Concordat] have been reformulated as minimum standards . . . which G-10 supervisory authorities expect each other to observe.").

195 *Id.* (Standard 4 states "If a host country authority determines that any one of the foregoing minimum standards is not met to its satisfaction, that authority could impose restrictive measures necessary to satisfy its prudential concerns consistent with these minimum standards, including the prohibition of the creation of banking establishments.").

196 *See, e.g.*, 12 U.S.C. § 3105(d)(2)(A) (applying "comprehensive supervision" rule to branch entry).

197 *Cf., e.g.*, 12 C.F.R. pt. 225, app. A, n.2 ("The risk-based capital measure [promulgated by the Federal Reserve System] is based upon a framework developed jointly by supervisory authorities from the countries represented on the Basel [*sic*] Committee on Banking Regulations and Supervisory Practices . . . and endorsed by the Group of Ten Central Bank Governors.").

rules and practices suggests that certain issuances of the Basel Committee in fact are accorded source-of-law recognition.[198] As the BIS itself has acknowledged, "[i]n many cases, supervisory authorities in non-G-10 countries have seen fit publicly to associate themselves with the Committee's initiatives."[199] The 1988 Capital Accord is currently used by regulators in over 100 countries to determine minimum capital reserves of banks subject to their supervision.[200]

Since U.S. law applies the 1988 Capital Accord to all depository institutions, adoption of the subsequent revisions to the Accord could pose particularly difficult regulatory issues concerning disparate treatment.[201] It has been estimated that the ten largest U.S. banks would adopt the more flexible IRB approach to capital adequacy, with perhaps the next largest ten to twenty banks also permitted to do so.[202] The remaining thousands of depository institutions would continue to be subject to the more restrictive regime of the 1988 Capital Accord.[203] Members of the Senate Banking Committee have raised critical questions about this dichotomy in treatment under Basel II.[204] For example, would lower capital costs for the largest twenty to thirty U.S. banks create an unjustifiable competitive disadvantage for large regional banks and smaller "community" banks? Could this situation result in a renewed wave of acquisitions, eliminating smaller banks that service local communities? Furthermore, competitive issues aside, do the revisions to the Accord give too much discretion to the largest banks to formulate the specific capital requirements that will apply to them?

IV. Conclusion

While it is true that the Basel Committee possesses no "formal supranational supervisory authority,"[205] that observation seems to

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198 *Id.*

199 BCBS, HISTORY OF THE BASEL COMMITTEE AND ITS MEMBERSHIP 5 (2001), https://www.bis.org/publ/bcbsc101.pdf [https://perma.cc/T5NP-X5MR].

200 Pruzin, *Basel Committee Cites Mixed Results*, *supra* note 98.

201 *See* MALLOY, BANKING LAW AND REGULATION, *supra* note 37, § 7.03[C][4][b] (discussing the stratification of the U.S. banking market if significantly different capital standards applied to internationally active banks and all other depository institutions).

202 R. Christian Bruce, *supra* note 100, at 1.

203 MALLOY, BANKING LAW AND REGULATION, *supra* note 37, § 7.03[C][4][b].

204 *See id.*

205 *Policy Development*, *supra* note 190.

beg the question that the contemporary practice of the committee seems to represent the emergence of a new kind of source of law. The activities of the Basel Committee result in concrete rules of law that represent an international administrative practice involving rule proposal for public comment, revision in light of public comments, and adoption, implementation, and enforcement at the national level.