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EVALUATING THE POLICY IMPLICATIONS OF THE OTHER TWO PILLARS OF BASEL II

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Abstract: This brief evaluates the supervisory-process and market-discipline pillars of the Basel II bank regulatory framework. It reviews and critiques their fundamental features and reaches three conclusions. First, the supervisory-process pillar provides too much scope for supervisory discretion and almost no support for a rules-based approach to regulation that arguably would be much more effective in promoting bank safety and soundness. Second, the market-discipline pillar's information-disclosure guidelines represent a useful first step for many nations with less-developed banking systems, but these costly guidelines fail to promote attainment of other conditions required to enhance market discipline in any of Basel II's participant nations. In light of these first two conclusions, the third conclusion is that these pillars of the Basel II framework require rethinking and reworking. In the longer term, global banking safety and soundness would more likely be enhanced by delaying implementation of Basel II until its framers replace the current supervisory-process pillar with a system of prompt-corrective action rules and expand the market-discipline pillar to include more features that might actually enhance bank market discipline.

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1. Introduction: The Other Two Pillars of Basel II

The framers of the proposed Basel II bank regulatory framework conceptualize this regulatory scheme as resting on three “pillars.” Pillar 1 is a redesigned system of risk-based capital requirements. Pillar 2 is a set of supervisory-process review guidelines. Pillar 3 is a system of rules aimed at promoting increased market discipline. This “pillar” analogy is appropriate. If any of the three pillars fails to provide support for the overall regulatory scheme, then the framework ultimately is likely to fail to promote long-run safety and soundness of the banking systems of the dozens of nations that have indicated an intention to participate.

The bulk of the research and discussion relating to Basel II has focused attention on the capital-regulation features of Pillar 1. This is perhaps not surprising, given that slightly more than 80 percent of the body of the public description of the policy pillars (Bank for International Settlements, 2006) is devoted to discussion of Pillar 1. Overall, the outstanding research finds at best lukewarm support for Basel II-style capital requirements [see, for example, Santos (2001) and VanHoose (2006, 2007a)]. In spite of the mixed evidence regarding effects of capital regulation on bank safety and soundness, U.S. regulators presently indicate they plan to retain Basel I-style leverage requirements alongside the new Basel II risk-based capital rules. Even some researchers who suggest that there is a role for capital regulation have questioned whether the benefits of risk-based capital regulation and leverage ratios justify the costs [see, for instance, Van den Heuvel (2005)]. Thus, one pillar of the Basel II tripod already may be somewhat wobbly.

What about the other two pillars? Will they reinforce the capital-requirement pillar sufficiently to offset any weakness in the relationship between capital regulation and bank

safety and soundness? This policy brief considers this question and concludes that the answer is no. There is a presumption inherent in the supervisory-process pillar that discretionary supervision is preferable to policy rules, but in fact this pillar could well have negative consequences for bank safety and soundness. In some respects, the market-discipline pillar represents a step forward, particularly for participating countries with less-developed banking systems. Nevertheless, aside from promoting regular releases of certain types of information, the market-discipline pillar actually would do little to promote stronger market discipline in banking in nations with well-developed banking systems.

2. Basel II Opts for Supervisory Discretion Over Policy Rules

The BIS document (Bank for International Settlements, 2006) describing the Basel II system lays out four principles underlying the supervisory-process pillar: (i) a requirement for “banks to have a process for assessing capital adequacy in relation to their overall risk profile and a strategy for maintaining their capital levels”; (ii) a statement of encouragement to national regulators to “review and evaluate banks’ internal capital adequacy assessments and strategies” and to “take appropriate supervisory action if they are not satisfied with the results”; (iii) suggestions that supervisors “should expect banks to operate above the minimum regulatory capital ratios” and “should have the ability to require banks to hold capital in excess of the minimum”; and (iv) a declaration that national regulators “should seek to intervene at an early stage to prevent capital from falling below the minimum level” and “should require rapid remedial action.” Furthermore, the document adds, “*Supervisors should have the discretion to use the tools suited to the circumstances of the bank and its operating environment* [italics added].”

This last sentence sums up the key policy import of the supervisory-process pillar: Under Basel II, national regulators have significant scope to engage in supervisory discretion. Principle (i) of the pillar clearly leaves it up to national regulators to determine

if banks are well, adequately, or inadequately capitalized relative to ratios specified in the Basel II framework. Further discussion of principle (ii) in the BIS document provides no guidance about how and when national supervisors are to undertake reviews of banks' internal assessments and strategies. This discussion refers only to "periodic review" involving on- or off-site examinations or discussions, external auditing, and "periodic reporting." The even briefer discussion of principle (iii) grants to national supervisors the determination of "whether the particular features of the markets for which they are responsible are adequately covered." With respect to principle (iv), the document suggests that "supervisors should consider a range of options if they become concerned that a bank is not meeting... requirements." It is left to the discretion of a given national regulator whether to enforce tough policy responses, such as requiring the offending bank to restrict dividend payments or to raise additional capital immediately, or to react instead in a more muted manner, such as by engaging in more intense "monitoring of the bank" or requiring it "to prepare and implement a satisfactory capital adequacy restoration plan."

This strong emphasis on supervisory discretion is problematic in two respects. First, purely discretionary policymaking conflicts with contrary recommendations across virtually the entire range of the academic literature spanning the past three decades. Second, significant national diversity in national regulatory standards conflicts with a key Basel objective of establishing a level international playing field in banking.

Opting for discretion signals that Basel II's framers have chosen to rely on the traditional assumption that government-granted powers give national supervisors the capabilities to induce solvency-promoting actions by bank managers. More than three decades of academic research evaluating the pros and cons of policy rules versus discretion have, however, cast considerable doubt on the efficacy of this assumption. Indeed, the literature evaluating rules versus discretion has almost uniformly trumpeted the benefits of pre-committed policymaking and brought to the forefront the dangers of relying exclusively on discretion. The fundamental difficulty of policy discretion is that a

discretionary policymaker faces a time-inconsistency problem: An announcement that the policymaker will engage in a future course of action will be non-credible if agents recognize that the policymaker actually will diverge from its pre-announced aim. The consequences often will prove to be politically expedient actions and socially costly outcomes.

There is considerable evidence, most recently gleaned from virtually worldwide experiences, that discretionary inefficiencies in bank regulation can generate incentive-perverse outcomes and unintended enlargements of moral-hazard problems. From the mid-1970s to the late 1990s, discretion in regulatory policy often resulted in regulatory forbearance in the face of weaknesses at troubled institutions. The end results were significant costs to taxpaying citizens throughout the world, such as U.S. taxpayers who provided billions of dollars to address insolvencies at numerous savings institutions. Furthermore, bank regulators engaging in discretion have persistently been tardy in adapting to institutional changes, particularly relating to growing complexities of increasingly multifaceted and globally based financial institutions. Discretionary regulatory policy has also proved to be slow to keep pace with broader evolutionary processes in banking markets, ranging from institutions' growing use of instruments such as credit derivatives to enlarged risk exposures in the subprime-mortgage market.

In contrast, policy rules, such as a specified set of prompt-corrective-action pre-commitments, would lay out clear arrangements for addressing institutional weaknesses irrespective of their source. In addition, even rudimentary policy rules—such as the 1991 Federal Deposit Insurance Corporation Improvement Act's system for automatically moving through a series of stages for dealing with troubled institutions through a series of tripwires—provides a framework for limiting the scope for regulatory forbearance. Such prompt-corrective-action guidelines are completely absent from the Basel II framework.

This inattention to the importance of rules-based bank regulation is unfortunate. Reference to Barth, Caprio, and Levine's (2004, 2006) comprehensive analyses of global

banking regulation indicates that Basel II's reliance on regulatory discretion is almost certain to prove counterproductive in the long run. Barth *et al.*'s cross-country studies suggest that nations in which bank supervisors have the greatest range of discretionary powers typically have the world's least developed, most corrupt, and poorest performing banking systems. In contrast, countries requiring bank regulators to operate with less discretion possess banking systems that are more developed, less corrupt, and stronger, safer, and sounder. On this basis alone, the discretionary approach of Basel II is inappropriate.

In addition, however, the absence of efforts to place banks in different countries on the same competitive footing by ensuring international coordination of supervisory standards runs against the grain of the entire Basel approach. Even now, prior to the full implementation of Basel II, regulatory divergences are creating concerns on this score. In light of simulations indicating that large U.S. banks' required capital levels could drop by more than 15 percent under Basel II, U.S. regulators have since early 2006 insisted that they intend to retain Basel I-style leverage-ratio requirements as part of their implementation strategy for Basel II [see Gilbert (2006) for a discussion of the retention of leverage ratios under Basel II]. European regulators, in contrast, have indicated an intent to allow capital levels to fall at European banks, as long as those banks otherwise abide by the new system's risk-linked capital requirements. Thus, under Basel II total capital costs of U.S. banks may rise even as costs of capital at European banks decline.

It remains to be seen just how different the supervisory rules put into place by different national regulators ultimately will turn out to be. Nevertheless, any such divergences in supervisory process could have the unintended consequence of creating competitive advantages or disadvantages based on a bank's location. One possible result, if such advantages were allowed to persist, could be regional regulatory arbitrage, with internationally active banks opting to change their home base—perhaps via relocations but more likely through cross-border mergers—in pursuit of a regulatory jurisdiction with the

weakest supervisory standards. Such an outcome would hardly promote enhanced global bank safety and soundness.

On net, it is hard to resist the conclusion that the supervisory-process pillar of Basel II is remarkably weak. This pillar emphasizes discretion over rules, which in turn is likely to promote regulatory forbearance instead of prompt corrective action. The supervisory-process pillar also permits a surprisingly large scope for national divergences in statutory standards and regulatory enforcement. The pillar has little to recommend it, except to nations anxious to avoid pre-committed policymaking in favor of politically motivated discretion.

3. Basel II Provides an Incomplete Scheme for Promoting Market Discipline

The centerpiece of the market-discipline pillar of Basel II is a set of guidelines for banks' disclosures of information. It is well understood by financial economists and policy makers [see, for instance, Lane (1993) and Flannery (2001)] that the availability of correct information at appropriate times is a key condition for effective market discipline. Accordingly, the market-discipline pillar is intended to "develop...a set of disclosure requirements which will allow market participants to assess key pieces of information on the scope of application, capital risk, exposures, risk assessment procedures, and hence the capital adequacy of [an] institution." Such disclosures "should be consistent with how [a bank's] senior management and...board of directors assess and manage...risks." Regarding the determination of appropriate information to disclose, a bank is to release material information which, if omitted or misstated, "could change or influence the assessment or decision by a user relying on that information for the purpose of making strategic decisions." It might be advantageous, the BIS document suggests, for information to be released semi-annually by most banks and quarterly by "large internationally active banks and other significant banks."

Of course, the release of basic information at appropriate times is only one of several conditions that must be satisfied if markets are to usefully discipline banks. In addition, incentives must be present for individual suppliers of funds to banks—depositors, debt holders, and equity owners—to react to timely and sufficient data in ways that provide clear signal to all other funds suppliers, bank managers, and regulators. Finally, banks must react to market signals (and perhaps market-induced regulator signals) in ways that actually end up promoting solvency-enhancing actions by bank managers.

Unfortunately, the Basel II framework provides no other market-discipline guidelines aimed at satisfying these additional conditions. There are strong arguments favoring the idea that liquid, unconcentrated markets for bank-issued bonds could enhance market discipline by creating larger constituencies of investors with incentives to carefully monitor banks' performances [see, for example, Hamalainen et al. (2003) and Llewellyn and Mayes (2003)]. Furthermore, there is evidence that distressed banks with greater relative involvement in markets for subordinated debt experience positive outcomes [see, for instance, Ashcraft (2006)] and that debt-Treasury rate spreads can signal relative degrees of financial strength [see, for example, Evanoff and Wall (2001) and Covitz, Hancock, and Kwast (2004)]. Nevertheless, Basel II is silent both about any possible direct disciplining role for these markets or about the potential for bank bond spreads to serve as useful signals to bank regulators.

Thus, the market-discipline pillar of Basel II promotes only a single *necessary* condition for effective market discipline of banking institutions: increased information disclosure, mostly in the form of data released no more often than each quarter and focused mainly on the status of bank's capital in relation to the rest of its balance sheet. It is not at all apparent, however, that promoting this one market-discipline condition alone will prove *sufficient* for markets to discipline banks via effective monitoring, correct assessment of risks, and appropriate, clear signals to bank managers and/or regulators. It is more likely that attainment of Basel II information-disclosure standards in developing

nations—at least, to the extent that supervisory discretion does not water down disclosure standards—will produce concrete benefits than in developed nations.

It is arguable that in already highly developed banking systems, a primary impact of the market-discipline standards will be that banks will incur significant costs to bring existing measuring and reporting systems into line with statutory requirements without many concrete benefits emerging. Of course, if new measurement and reporting systems turn out to be true enhancements over systems previously in place in developed nations, significant market-monitoring benefits could be forthcoming. Nevertheless, at present there is no empirical evidence regarding likely relative magnitudes of the associated costs and benefits in developed countries. Thus, in the absence of other Basel II features aimed at promoting changes sufficient to enhance either true market discipline or market signals for regulatory use, it seems unlikely that market-discipline pillar in developed nations will promote additional market discipline. Nor will the market-discipline pillar do anything to promote stronger and more accurate market signals that regulators might utilize to identify and/or monitor troubled institutions.

4. Rethinking Basel II's Supervisory-Process and Market-Discipline Pillars

The Basel II framers' "blessing" of supervisory discretion is unambiguously a step in the wrong direction. A clear system of regulatory rules would enhance bank safety and soundness. Continued or even increased regulatory discretion could well promote diminished performance and failures.

The framers' establishment of a market-discipline pillar is a step in the right direction, but it is only one of several steps that would be required to truly enhance market discipline. Implementing the market-discipline pillar also seems to have been designed to be as expensive as possible for banking systems that already exhibit considerable informational transparency.

Let's consider alternative approaches to these two pillars of Basel II.

4.1 Revamping the Supervisory-Process Pillar

As presently conceived, the supervisory-process pillar is highly unlikely to promote greater safety and soundness of the world's banking systems. Indeed, the Basel II supervisory-process guidelines are at exactly the wrong end of the discretion-rules spectrum. Generally speaking, therefore, any shift away from the current, highly inferior guidelines toward a system of rules would constitute a movement in the right direction. Consequently, it is tempting to say that almost “anything” could prove to be an improvement over Basel II's present supervisory-process pillar.

More constructive, however, would be to contemplate how the framers of the system might replace the existing pillar with something closer to a first-best alternative. A first-best supervisory-process pillar would require Basel II participants to utilize essentially the same supervisory standards and to implement fully specified prompt-corrective-action rules. Such rules would clearly establish tripwires—supervisory examination results, market signal revelations, and the like—that would generate specific actions that regulators would pre-commit to applying in equal measure to any troubled institution exhibiting a pre-announced set of characteristics.

Such a rules-based approach would provide several benefits. First, it would help to insulate national regulators from political pressures from their governments, who could respond to such pressures by pointing out that they are only adhering to their responsibility to abide by such a Basel II “rules” pillar. Second, adopting a rules-based pillar would greatly diminish the capability of national regulators to engage in forbearance policies that often allow troubles to fester and social costs to mount. Third, as documented by Barth *et al.*, the likely long-run effects of adherence to rules-based supervisory-process guidelines would be more developed, less corrupt, and better performing banking systems. Fourth, establishment of virtually identical bank regulatory standards and concrete, pre-specified supervisory enforcement rules would make competitive rules of the game transparent and would provide for a level global playing field.

4.2. Strengthening the Market-Discipline Pillar

With respect to the market-discipline pillar, Basel II's framers should revisit the issue of benefits versus costs. For developing nations that presently have non-transparent banking systems, there is a strong argument for implementing brand new systems and procedures for disclosing information. In these nations, the benefits are more likely to exceed the costs. This argument is much weaker in nations in which banking systems are already relative transparent and in which relatively low-cost "tweaking" surely would yield benefits nearly as great as wholesale replacement of existing disclosure mechanisms.

The market-discipline pillar would be improved markedly by including a provision placing caps on government depositor guarantees, such as common international limits on deposit insurance and abolishment of all too-big-to-fail promises. Such actions would provide depositors, bondholders, and equity owners with greater incentives to monitor the risk characteristics of banks and, by their market reactions in light of these incentives, give both market participants and regulators clearer signals about each bank's safety and soundness.

Another useful addition to the market-discipline pillar would be to promote the development of liquid bank-bond markets with dispersed investor involvement, thereby setting the stage for more effective market discipline of bank managers by bond investors. A number of proposals for *required* issuance of subordinated debt are already outstanding [see, for example, Evanoff and Wall (2000), Bliss (2001), Calomiris (1999), and Kwast et al. (1999)], and the framers of Basel II would do great service by giving such proposals more than just the passing consideration they have received from policymakers to date.

Even if Basel II's framers were to conclude that a mandated subordinated-debt arrangement would be unjustified at present, they could do much future good by encouraging national regulators to initiate studies of how market signals already available might supplement the supervisory process. On net, evidence examined in the academic literature [see VanHoose (2007b) for a review] suggests that information provided by

signals in markets for banks' debts and equities could usefully complement traditional supervisory monitoring. Further evidence from a wider variety of locales—most research has focused on the usefulness of market signals in the United States and Europe—would be useful at some future date when a “Basel III” system is under consideration.

5. Conclusion

Should participating nations go forward with Basel II? Kane (2006) effectively argues that the answer is “not yet.” In his view, nations contemplating participation in the Basel II Accord should not agree to a scheme that is obviously inferior to alternatives. He suggests that U.S. regulators should seek renegotiate the accord, which he concludes is not in the interest of the U.S. banking system in light of the significant policy discretion granted other nations, particularly in Europe. Kaufman (2006) contends the entire Basel II scheme is inferior to a system of prompt-corrective-action rules. In his view, Basel II is a little more than “costly distraction” from the objective of improved global banking safety and soundness.

This paper's evaluation of the supervisory-process and market-discipline pillars supports Kane's and Kaufman's conclusions. Much of the previous literature on capital requirements has shown that in its present form the capital-regulation pillar has a weak intellectual foundation. In addition, as discussed in this paper, the supervisory-process pillar is misguided, and the market-discipline pillar is, at least for most developed nations, no more than a baby step unlikely to promote much actual discipline.

Even if the present capital-regulation pillar remains in place, the other two pillars require considerable restructuring. Currently, the Basel II scheme is slated to be phased in gradually beginning in 2008. It would be appropriate to delay this timetable further, so that the pillars of Basel II can be redesigned to be truly reinforcing features of a new global system for bank regulation.

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