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Musings on the Seeming Inevitability of Global Convergence in Banking Law

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MUSINGS ON THE SEEMING INEVITABILITY OF GLOBAL CONVERGENCE IN BANKING LAW

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INTRODUCTION

In the past decade, there has been heated debate over the extent to which global convergence in corporate governance is attainable and desirable. One thing is clear, however; international convergence in corporate governance law has not been achieved.1 Many would ascribe that fact, among other

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things, to incompatible differences between market systems of corporate governance, which have widely dispersed stock ownership and deep, liquid stock markets, and block-holding systems, in which stocks are thinly traded and control is held by insiders or banks. Market systems of corporate governance typify the United States and Britain, while block-holding systems are found in continental Europe, East Asia and most other capitalist economies.2

The nature of a system often shapes the legal relationships between corporations and banks as financiers. Thus, in the United States, the most prominent market system, banks are generally prohibited from owning equity stakes in the corporations to which they lend, partly to avoid connected lending to corporate affiliates of banks and partly to avoid aggregation of financial power.3 In contrast, in Germany and Japan (both of which are block-holding systems), connected lending and equity ownership by banks are mainstays of corporate finance. In both of those countries, banks traditionally have been the largest equity-holders in major corporate borrowers and have used their equity stakes to monitor loans. The same pattern exists in many transition economies, albeit often without the safeguards that exist in Germany.

Other important implications flow from differences in the relative importance of capital markets and bank finance in market and block-holding systems. Market systems put a premium on transparency and disclosure because shareholders are typically dispersed and cannot monitor their

2. E.g., Bratton & McCahery, supra note 1, at 218; Coffee, supra note 1, at 641-42, 647-48.

investments through day-to-day involvement. In contrast, block-holding systems normally favor opacity over disclosure. In part, that is because dispersed ownership is uncommon; in part, it is because lack of transparency deters other competitors from doing business with corporate borrowers, thereby enabling the banks that lend to them to obtain captive returns on their investments. As a result, finance in block-holding systems tends to rely on relationships of trust more than on impersonal markets and judicially enforceable contracts.4

Market and block-holding systems also differ in the level of protections that are accorded to minority shareholders. In block-holding systems, protections for minority investors are generally weaker than in market systems. As a result, shareholders demand control stakes in block-holding systems in order to protect their investments.

Given these differences between market systems and block-holding systems, one might surmise that the same structural impediments to international convergence in the corporate governance area would crop up in cross-border banking regulation. In fact, however, convergence has made greater headway in banking law than in corporate governance law. Furthermore, the trend toward global convergence in banking cuts across market and block-holding systems alike.

Given the close relationship between banks and corporate governance, why has global convergence in banking made greater strides than in corporate governance law? At first blush, one might suppose that the movement toward international convergence in banking is propelled by Darwinian notions of efficiency, i.e., the idea that one set of regulatory principles will result in optimal banking operations around the world and that systems that fail to evolve toward those principles are doomed to failure. If that were the case, however, why would banking regulation be any more conducive to uniform oversight based on efficiency notions than corporate governance?

This article sets out to examine these questions. I begin by describing the forces behind global convergence in banking regulation and how those forces differ from the constellation of forces affecting convergence in corporate governance. In that regard, I suggest that global convergence in banking has been reactive in nature and has responded more to perceived threats than to idealized notions of efficiency. Nevertheless, the outcome of that

international project has been to produce unitary standards that emulate specific efficiency paradigms. Accordingly, it is necessary to consider whether those efficiency notions represent an inevitable development or whether global convergence in banking is a transient phenomenon that contains the seeds of instability. I conclude that the efficiency paradigm that is implicit in the Basel Committee's pronouncements is an impoverished model that fails to account for broader systemic tradeoffs and varying stages of economic development.

I. GLOBAL CONVERGENCE IN BANKING REGULATION AND ITS UNDERLYING FORCES

Why has global convergence in banking advanced farther than in corporate governance? After all, the efficiency norms that are imbedded in international banking standards arguably apply to corporations of all types. As I will explain, however, the greater speed with which international standards emerged in banking was a function of concerns that are unique to the financial services industry and that are otherwise absent in corporate governance, i.e., worldwide financial contagion and fears about ensuing political unrest. Due to the often-urgent nature of those concerns, the Basel Committee has been able to achieve at least surface agreement on international banking standards, despite major differences between market and block-holding systems.

A. The MOVEMENT TOWARD GLOBAL STANDARDS IN BANKING

The movement toward uniform global banking standards began in the mid-1970s, triggered by the failure of the Bankhaus Herstatt in West

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5. Global convergence can come in a variety of forms, including binding treaties, voluntary compliance with multilateral standards, standardization of industry practices or conscious parallelism in the enactment of national laws. In banking regulation, the movement toward uniform standards has been accomplished, not through treaties, but through "soft law" in the form of model principles and guidelines, developed by the Basel Committee on Banking Supervision, for adoption on a voluntary basis by signatory countries. E.g., Lawrence L.C. Lee, The Basle Accords as Soft Law: Strengthening International Banking Supervision, 39 VA. J. INT'L L. 1, 3-6 (1998). Consequently, I will use "convergence" as it applies to banking regulation to denote non-binding multilateral standards that individual sovereign nations adopt as law.

The Basel Committee's accomplishments are not the only evidence of convergence. Further movement in that direction can be seen in the General Agreement on Trade in Services and the European Union's Second Banking Directive. See, e.g., Mary E. Footer, GATT and
Germany in 1974. Under the auspices of the Bank of International Settlements (BIS) in Basel, Switzerland, the Group of 10 (the G-10) linked arms with Luxembourg and Switzerland to form what is known today as the Basel Committee on Banking Supervision. The Basel Committee's stated purpose is to encourage progress toward convergence in the banking regulations of its members by promulgating model standards and serving as an information exchange. While the Basel Committee's standards are non-binding, they are endorsed by the governors of the G-10 central banks and are formulated with the expectation of adoption by G-10 members.

The earliest pronouncements of the Basel Committee addressed the anomaly that banks were increasingly multinational, but regulation was national in scope. Growth in international trade had spurred growth in international banking. Advances in computerization and the management of risk through derivatives had also fueled growth. The progressive dismantling of restrictions on capital movements in many countries caused foreign currency trading to surge, especially on the financial derivatives markets. Indeed, ultimately in recognition of that growth, the Uruguay Round's General Agreement on Trade in Services (G.A.T.S.) was hammered out to liberalize cross-border trade in financial services.

The cross-border expansion of banking in the past thirty years, however, came at the expense of worldwide financial contagion. Repeatedly, banking regulators have been saddled with crises after foreign activities by local banks.

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7. Id. The G-10 consists of Belgium, Canada, France, Germany, Italy, Japan, the Netherlands, Sweden, the United Kingdom and the United States. Id. at 248 n.16.
8. Id. at 262.
10. See Footer, supra note 5, at 345-51.
evaded regulation and resulted in bank failures, inflicting losses at home. Comparable harm occurred when poorly supervised foreign banks expanded overseas and wreaked damage on their host countries. In response, the Basel Committee's first major initiative, the Basel Concordat of 1975, formulated guidelines for consolidated supervision by home countries and host countries of the foreign activities of banks. Later sovereign debt crises prompted the Basel Committee to revise the Concordat in 1983 and to supplement the Revised Concordat in 1990. A year later, in 1991, the notorious failure of the Bank of Credit and Commerce International (BCCI) sent shock-waves around the world and caused the Basel Committee, in 1992, to issue new minimum standards for the supervision of international banking groups.

As this chronology suggests, the Basel Committee's earliest concerns were with cross-border supervision. Only later did the Basel Committee turn to the substantive content of banking regulation. In 1988, the Basel Committee issued the Basel Accord, which called for minimum capital standards for commercial banks pegged at eight percent of risk-weighted assets. Capital adequacy is a mainstay of banking regulation: it seeks to ensure that banks have an adequate cushion against losses for the protection of depositors. The Basel Committee's contribution was to require higher-risk

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banks to maintain commensurately higher capital. Since its appearance twelve years ago, the Basel Accord has had astonishingly wide acceptance, with adoption by approximately one hundred countries. If anything epitomizes the movement toward global convergence in financial services regulation, it is unquestionably the Basel Accord.

The Basel Committee's moorings in fixed notions of economic efficiency are most evident from its substantive banking standards. The Basel Accord proceeded on the premise that a single capital structure, based on a minimum capital ratio of eight percent, was universally optimal for banks, both in terms of return on equity and adequate protection for depositors or their insurers. As such, it embraced a determinist notion of economic efficiency that assumed, as Professor John Coffee has put it in a somewhat different context, that "large-scale firms [would] adopt a common set of structural characteristics" and would not subsequently depart from that predetermined equilibrium.

The same lockstep notions of efficiency appeared in the Basel Committee's more ambitious attempt a decade later to formulate a comprehensive regime for the prudential regulation of commercial banks. In 1997, the Basel Committee issued the Core Principles for Effective Banking Supervision, its most comprehensive set of banking standards to date. In a set of twenty-five core principles, the Basel Committee formulated substantive standards on everything from the preconditions for effective banking supervision and chartering standards to risk management, examinations, disclosure and enforcement.

In considering the efficiency rationale behind those standards, it is worth examining the example of Principle 10 of the Core Principles on "connected lending." Principle 10 states:

In order to prevent abuses arising from connected lending, banking supervisors must have in place requirements that banks lend to related companies and individuals on an arm's-
length basis, that such extensions of credit are effectively monitored, and that other appropriate steps are taken to control or mitigate the risks. 20

Thus, the embedded notion is that efficiency is to be measured, in isolation, by terms that would be extended to previously unfamiliar borrowers, without regard for the feasibility of setting those terms or other social benefits that might accrue from connected lending to related borrowers.

This formulation of efficiency is inextricably bound up with the Basel Committee's moorings in the Western industrialized world and particularly in market systems, primarily the United Kingdom and the United States. The Basel Committee, as Stephen Zamora has described it, is "an exclusive club representing the central banks of the most highly (Group of Ten) industrialized countries" and consists of the major powers of Western Europe, the United States and Japan. 21 Until recently, the Basel Committee assiduously resisted expanding the Committee's membership to Third World countries. 22 Furthermore, it is generally agreed that the 1988 Basel Accord was the product of behind-the-scenes maneuvering by the two most important market systems, the United Kingdom and the United States. 23

20. Id. at 27.


This is not to say that the G-10 regularly achieves full consensus. There are many topics about which the bank supervisors of the different G-10 nations have failed to agree. Examples include the debate over activities restrictions and universal banking, the optimal degree of concentration within the banking industry, state subsidies to local banks and bank secrecy. E.g., Heidi Mandanis Schooner & Michael Taylor, Convergence and Competition: The Case of Bank Regulation in Britain and the United States, 20 MICH. J. INT'L L. 595 (1999); German Banks Under Fire, THE ECONOMIST, May 22, 1999; Bank Rules in Disarray, THE ECONOMIST, Nov. 27, 1999, at 75.

22. JOSEPH JUDE NORTON, DEVISING INTERNATIONAL BANK SUPERVISORY STANDARDS 229 (1995) [hereinafter STANDARDS].

23. The Basel Accord was hammered out in haste after the United States, the United Kingdom and Japan proposed their own trilateral agreement on capital standards, the effect of which would have been to raise the bar to entry by most of the world's other major banks. The following protest by one observer captured that dynamic and the tension that ensued:

The two countries [the United States and the United Kingdom] -- the homes of the two largest financial centres in the world -- have agreed to a joint approach in defining the capital of banks, laying down a system for valuing banks' assets including off-balance-sheet operations and allocating them to specific categories or risk. As a next step, they are trying to reach agreement with Japan. This would cover the three most important
In more recent years, stung by allegations of hegemony on the part of Western capital-exporting powers, the Basel Committee decided to include banking supervisors from offshore countries and emerging economies in its deliberations in order to enlist their enforcement on a voluntary basis and confer greater legitimacy on the Committee's efforts. The Basel Committee's standards have also been enforced in emerging economies through considerably more coercive means. The most potent means of such enforcement in recent years has been International Monetary Fund (IMF) conditionality, whereby the IMF has insisted on compliance with the Basel Accord and the Core Principles as a condition of aid.

B. THE DRIVING FORCES BEHIND INTERNATIONALIZATION OF BANK REGULATORY STANDARDS

In corporate governance, as opposed to banking, there is no pretense of a consensus among the G-10 nations on an optimal set of standards. Commentators have advanced a number of explanations for this state of affairs, including political rent seeking and path dependency, the role of legal financial centres in the world. Countries not prepared to join an agreement among this group of three countries could easily be put under pressure. It would be sufficient to bar their banks from using the three financial centres or to subject them to special treatment. If they wish to remain competitive internationally, the large banks that operate worldwide can no longer be absent from these centres today. They would quickly try to encourage their governments to co-operate internationally.

However, should the example set a precedent and the strategy of the two powers be extended to other fields of harmonising banking supervision -- as a substitute, so to speak, for internationally negotiated compromises -- then the willingness to co-operate internationally could suffer damage in the long run. In view of the problems that need to be solved, this would be a harmful development.


institutions in shaping the preconditions for efficiency, and varying liquidity preferences.\textsuperscript{26}

So why has consensus in the banking area been easier to achieve? After all, the banking regimes in the G-10 countries grow out of the same political milieu as corporate governance regimes. Furthermore, one could argue that the determinist notions of economic efficiency that undergird the Basel Committee's substantive pronouncements apply equally to corporate governance.

Nonetheless, global convergence has made greater headway in banking than in corporate governance. That can be explained, in large part, by many of the same reasons that cause governments to regulate banks in the first place. The preeminent reason, systemic risk, is reactive in nature and flows from common concerns by national bank supervisors about the domestic repercussions of cross-border banking crises that they cannot individually control. As in corporate governance, it has not been enough to subscribe to the view that international corporations are evolving toward a common ideal of efficiency. Rather, in banking, the main impetus towards harmonization consisted of international banking crises of catastrophic proportions that could not be quelled without international cooperation.

The roots of systemic risk lie in the capital structure and mutual interdependence of banks.\textsuperscript{27} Banks obtain the bulk of their funds from debt in the form of demand deposits, rather than from shareholders' equity. Because banks borrow short and lend long, they suffer from a fundamental mismatch in the maturities of their assets (which are usually illiquid) and their liabilities (which are liquid). When depositors demand more funds than the bank has on hand, the result can be a devastating bank run.

Ordinarily, under the law of fractional reserves, banks can estimate how much money to have on hand each day to satisfy depositors' needs. If rumors or reports of bank distress circulate, however, causing depositors to fear an imminent bank run, that fear can become a self-fulfilling prophecy. Absent a lender of last resort, a bank that experiences a run will not be able to pay off its depositors because it will not be able to liquidate its assets immediately at full value. Depositors unlucky enough to stand at the back of the line will lose their money and the bank will close its doors.

\textsuperscript{26} E.g., Coffee, \textit{supra} note 1, at 642-48.

\textsuperscript{27} For fuller discussion of these dynamics, \textit{e.g.}, McCoy, \textit{supra} note 3, at 1-1 through 1-24.
As this suggests, solicitude for depositors is part of the motivation behind government regulation of banks, both out of concern for political instability and to encourage households to channel their savings into the economy. Thus, a fundamental purpose of banking regulation is to solve the information asymmetry that exists between banks and their depositors by interposing the government as a monitor. Monitoring by demand depositors is normally not cost-effective due to depositors' lack of information about their banks and the small size of their deposits. Even if monitoring were possible, depositors usually find it more cost-effective to exercise their rights of immediate exit through withdrawal than to engage in continuous monitoring.

Depositors are not the only subject of concern for government regulators. Governments also monitor banks out of concern for systemic risk. Banks are inextricably linked to one another through the payments system, as well as through an intricate web of inter-bank lending and derivatives swaps. As a result of those linkages, if a major bank fails and defaults on its obligations, other banks may fail, causing a ripple effect throughout the banking system. Insofar as banks are levers of monetary policy, the ensuing bank panic can have profound negative macroeconomic consequences, including contraction of the money supply and a resulting economic downturn. As such, systemic risk constitutes a negative externality of banks, because failed banks and their shareholders do not have to pay for systemic harms they inflict on other banks and other economies. As the largest banks grow larger, moreover, the danger of contagion grows. While the likelihood of contagion is subject to debate, governments are loath to risk it because the consequences can be devastating.28

In the global context, contagion is of even greater concern, not only because of the vast size and scope of international banking operations, but because jurisdictional boundaries hamper the ability of bank regulators, both de jure and de facto, to supervise banking operations abroad. Losses from speculative overseas banking activities can easily spread to a bank's home country, inflicting losses which regulators are helpless to prevent.

For these reasons, systemic risk has been the most powerful driving force behind the Basel Committee's pronouncements. As the Basel Committee noted with respect to the Basel Accord, the Committee "believed that the [capital adequacy] framework would help to strengthen the soundness and stability of the international banking system by encouraging international banking organizations to boost their capital positions."29 Indeed, the bulk of the Basel Committee's initiatives have been undertaken in response to global banking crises. Whenever major international banking scandals have roiled the financial world in recent years -- witness Franklin National Bank, Bankhaus Herstatt, Banco Ambrosiano in Italy, Continental Illinois, BCCI and Baring Bank -- the Basel Committee has regularly responded with a regulatory pronouncement.30 The thrust of those pronouncements has been to assure uniformly high prudential safeguards throughout major banking markets and cross-border enforcement. The collapse of the Thai bhat in 1997 and the Russian ruble in 1998, with their worldwide repercussions, underscored the frailties of interdependent markets and the need for global coordination and oversight.31

In contrast, outside of the financial services industry, contagion almost never is a concern in corporate governance. The reason why is that other types of corporations do not have to resort to the highly unstable device of demand deposits in order to finance their operations. Established corporations get outside financing through equity and through loans; other corporations that lack access to outside financing achieve growth through retained earnings. While the assets of most corporations are illiquid, so are their liabilities, which normally cannot be withdrawn immediately upon demand.32 Consequently, in industrial corporations, rapid contagion is not a concern as it is in banking. To be sure, one corporation's death may lead to the eventual failure of other corporations that are its suppliers, but the illiquid nature of their liabilities means that failure will be slow rather than precipitous, allowing time for countermeasures and intervention. Thus, discussions of corporate governance are almost never animated by concerns over the larger macroeconomic consequences of corporate failures.

29. BASEL ACCORD STUDY, supra note 16, at 1.
30. E.g., Norton, supra note 6, at 245-46.
31. See generally Lichtenstein, supra note 24, at 807.
32. Notes that are subject to call upon default are an exception.
Similarly, systemic risk is closely related to the other motivating factors behind the Basel Committee's standards, i.e., competitive parity and market entry. In major Western countries, governments reserve discretion to deny entry to the banking industry through charter denials. While entry controls in banking have obvious anti-competitive implications, normally they are justified as necessary to ensuring the solvency of banks. Concerns about lax oversight are often stronger for overseas banks than for their domestic counterparts, which is one reason why entry controls are often imposed on foreign banks. Given those supervisory concerns, uniform regulatory standards can help open markets by providing host countries with some assurance that the identical regulatory standards are being enforced in the home country of a foreign competitor. Similarly, for foreign banks that have already achieved market entry abroad, "a standard approach applied to internationally active banks in different countries" helps reduce competitive inequalities.33

Obviously, in corporate governance generally, market entry is of concern as well. In trade for goods as opposed to financial services, however, usually the concern is with market entry in a narrower sense. Corporations that are in the business of selling goods almost never are subject to barriers against entering foreign markets due to reservations by the host country about their form of corporate governance. In other words, in manufacturing, whatever market barriers exist operate against the entry of particular goods rather than against particular companies or particular forms of corporate governance. In contrast, in the area of bank regulation, market controls are elevated to the level of outright prohibitions against firms, based at least in part on solvency concerns. Thus, the stakes associated with market entry in banking are usually considerably higher than for firms that are not financial services providers.

Lastly, it is necessary to observe that international convergence in banking, in contrast with corporate governance, has occurred in less visible fora where change may be easier to accomplish. In civil law jurisdictions and increasingly in common law jurisdictions, corporate governance law is formulated by the legislature, often in the harsh glare of publicity. In contrast, the bulk of international banking standards are initiated by the Basel Committee, which attempts whenever possible to operate informally and behind closed doors.34 Once a particular set of principles has been

33. BASEL ACCORD STUDY, supra note 16, at 1.
34. Norton, supra note 6, at 249.
formulated and endorsed by the G-10, adoption of those principles may be accomplished by executive decree or agency order in many countries, without the need for statutory enactment. The obscure nature of capital adequacy rules and other forms of banking regulation aid the Basel Committee's attempts to preserve a low profile. As a result, political impediments to convergence in banking regulation, at least initially, may be lower than in corporate governance. At the same time, the behind-the-scenes nature of that process raises very real questions of political legitimacy.

To summarize, concerns about systemic risk, market entry and competitive parity coalesced in global harmonization in banking to a degree not yet seen in corporate governance law. Despite that rather remarkable accomplishment, the Basel Accord, in implementation, has developed fissures that cannot be ignored.

II. CENTRIFUGAL FORCES IN GLOBAL CONVERGENCE

I have argued that the result of the Basel Committee's initiatives has been to promote a uniform conception of economic efficiency. Nevertheless, it would be a grave mistake, based on a single snapshot, to conclude that convergence toward a unitary norm of economic efficiency is inevitable. It is a common failing to treat harmonization as a unidirectional movement, rather than as a series of reactions and counter-reactions that may trigger movements toward and away from shifting equilibria. Accordingly, it is important to ask whether the Basel Committee and its member states are

35. As recent moves toward deregulation in the United States have shown, efficiency norms do not necessarily result in stricter regulation. Regulators face a mixed array of considerations and pressures when attempting to formulate optimal levels of regulation. Nevertheless, among the major capital-exporting countries, fears about systemic risk from international contagion have been sufficiently insistent that the Basel Committee's products have generally resulted in stricter standards to date.

Due to the newness of the Core Principles, most of the available data bears on the Basel Accord's effect on capital adequacy levels. The Basel Committee recently concluded "that at least initially, the introduction of formal minimum capital requirements across the G-10 appears to have induced relatively weakly capitalized institutions to maintain higher capital ratios." Basel Accord Study, supra note 16, at 2. Moreover, "those countries which were close to, or below, the Basle minimum capital adequacy ratio of 8% in 1988 evidenced a much higher overall increase than those which had historically high capital ratios." Id. at 6-15. In the study, the Basel Committee was unable to conclude definitively, however, that the Basel capital adequacy ratios were responsible for the increase, as opposed to increased bank supervision or market discipline. Id. at 15.
subject to pressures that could cause banks or member states to depart from the Committee's supposedly efficient norms.

The seemingly rosy progress of the Basel Committee to date might suggest that centrifugal forces are not at work. In the short run, the confluence of forces has favored stricter uniform standards. Regulators are not the sole impetus for uniformity in banking, moreover; the impetus also comes from major international banks. Uniformity helps international banks by leveling the playing field so that regulated banks in one country do not suffer a cost disadvantage vis-à-vis their peers abroad due to stiffer regulatory requirements at home. Precisely for that reason, competitive equality was one of the stated rationales for the 1988 Basel capital adequacy accord.36

In the international arena, the strongest large banks have furthermore favored stricter uniform standards in order to hurt weaker competitors. If uniform standards are set sufficiently high, weaker banks will not be able to meet them and will either be acquired by stronger banks or close their doors. The Basel Accord, which raised minimum capital levels above the then-prevailing average in the United States, is just one example. In the United States, numerous weakened banks were acquired in mergers after the United States adopted risk-based capital standards under the 1988 Basel Accord.37 Similarly, higher uniform standards can eliminate potential future competition by setting a higher (and sometimes insuperable) bar to new entrants to the industry. This phenomenon has been the source of endless controversy in emerging economies, where fledgling domestic banks complain that major Western international banks have exerted pressure for adherence to global prudential standards in order to corner the market for banking services.38

Other private benefits inure to major international banks from uniform regulation. From the standpoint of cost savings and efficiency, international banks would prefer to operate on a consolidated basis, with one set of capital rules, accounting standards, internal controls, regulatory reports and books.39

36. E.g., Zamora, supra note 21, at 1958.
Since a single international regulatory system is nowhere close to a reality, international banks must settle for a second-best solution, in the form of substantial uniformity across the various national banking regulation regimes. Thus, a subsidiary goal of cross-border uniformity is a lower cost structure and greater economies of scope and scale for international banks.

Notwithstanding the competitive motives of large international banks, emerging economies may have reasons of their own to sign on to the Basel Committee standards. Domestic banks in emerging economies that want to attract major Western firms as clients and establish correspondent relationships find it easier to establish customer trust by observing the Basel Committee standards. Foreign investors are unwilling to use local banks for their banking and payments needs unless the safety of their deposits can be assured. Absent a credible system of deposit insurance guarantees, compliance with rigorous international standards sends a signal that a bank can be trusted with one's deposits. As banks in emerging economies mature, moreover, and extend their own operations abroad, they will need to comply with Basel Committee standards in order to gain entry to the major Western banking centers. Finally, in times of domestic monetary crisis, compliance with the Basel Committee's standards is a standard condition of IMF aid.

Nevertheless, the championing of a single, lockstep model of economic efficiency will inevitably be followed by antithesis in the form of economic and political destabilization. One source of instability inheres in the law of cartels. Another source of instability grows out of the fact that market systems and block-holding systems have deep-seated differences in their constructs of economic efficiency. These latter differences are especially apparent in norms concerning connected lending.

A. Cartel Dynamics

First, with respect to the law of cartels: one way to view the Basel Committee's actions is as the actions of a cartel (one that is governmentally sanctioned). Under the auspices of that cartel, the members of the G-10, through the Basel Committee, have agreed on a pricing structure for a regulatory tax on the business of banking. In keeping with the Basel Committee's pronouncements, that regulatory tax is supposed to be uniform throughout signatory countries through adherence to common standards. The
signatory countries include most, if not all, of the major financial centers of the world and control the majority of bank financing worldwide. Thus, by imposing higher standards, the Basel Committee can control the supply of financial services to a significant extent and maintain prices.

The devil, however, lies in enforcement. As with any cartel, the Basel Committee is susceptible to cheating by individual banks and member states. Member states have an incentive to relax their enforcement of the Core Principles and the Basel Accord whenever they can derive net benefits without getting caught.

In many cases, it is relatively easy for a country to cheat on the Core Principles and the Basel Accord and evade detection, at least in the short to medium term. Banking regulation is notoriously opaque around the world, with respect to disclosures by regulators and by banks themselves. Unlike securities regulation, which is premised on transparency and disclosure, banking regulation regimes around the world are highly secretive, even in societies that are otherwise open, in part due to fears about bank runs. Compounding this problem, because the Basel Committee operates through consensual standards, it lacks formal enforcement mechanisms. Unlike the regulatory system of a single sovereign nation, there is no international super-regulator with binding authority to keep national regulators in line. Accordingly, whether a country's banking regulators enforce the Basel Committee's principles once those principles become law may be difficult to ascertain, except from anecdotal evidence.

Another inducement to cheating consists of the fact that accounting treatments can give a false appearance of compliance. Although international accounting systems have moved towards common norms, significant national differences in accounting treatments remain. The effectiveness of risk-weighted capital, for instance, has a lot to do with whether assets are represented at cost (in which case the sting may be less

41. While this point has been briefly mentioned in passing, it has not been developed in the literature. E.g., Eric J. Gouvin, Banking in North America: The Triumph of Public Choice over Public Policy, 32 CORNELL INT'L L.J. 1, 26 (1998).


harsh) or fair market value. These differences make it harder to detect the extent of any cheating.

Other cheating is easier to detect, but difficult to counteract absent an overarching regulator. Thus, in recent years, German regulators have been accused of manipulating the risk-weight categories in two respects. They have given unduly low weights to bonds issued by German mortgage banks. In addition, they have permitted German banks to meet core capital requirements through a form of subordinated debt that other G-10 regulators had agreed to prohibit.44

Finally, banks and nations can evade higher standards through regulatory arbitrage, which is not strictly cheating but lawful exploitation of intentional or unintentional regulatory loopholes in a manner that violates the spirit of the standards. Under the 1988 Basel capital adequacy accord (the substantive Basel pronouncement with the longest track record), four prominent examples of regulatory arbitrage can be discerned.

1. Securitization

The most important example of regulatory arbitrage under the Basel Accord has been the use of securitization by United States and European banks to sell off loans to avoid higher capital requirements that otherwise would apply if those loans remained on the books. In securitizations, banks bundle their loans or other assets and sell interests in those bundles to the public in the form of securities that are backed by the assets. A window for regulatory arbitrage occurs because banks sign recourse clauses in which they

44. German Banks Under Fire, supra note 21, at 20; Germany's Protective Wings, THE ECONOMIST, May 22, 1999, at 83; Bank Rules in Disarray, supra note 21, at 75-76.

In the negotiations leading up to the 1999 proposed revisions to the Basel Accord, Germany continued to press for special treatment. The negotiations over the revisions became deadlocked when Germany insisted on a special German exception to the one hundred percent weight for commercial-property lending, on grounds that such lending has been low-risk historically in Germany when compared with other countries. Germany's Protective Wings, supra note 21, at 82-83; see also Bank Rules in Disarray, supra note 21, at 76. In the proposal, the Committee broke the logjam by stating that "mortgages on commercial real estate do not, in principle, justify other than a 100% weighting for loans secured." BASEL COMMITTEE ON BANKING SUPERVISION, A New Capital Adequacy Framework 31 (June 1999), available at http://www.bis.org/publ/index.htm (emphasis added). The Economist later jibed that the "two weasel words . . . 'in principle' were designed to 'allow Germans (but, with luck, nobody else) to give their mortgage banks generous treatment." Growing Basle, THE ECONOMIST, June 5, 1999, at 70. See also Daniel Pruzin, Capital Requirements: Basle Committee's Capital Proposals Aim to Measure True Risks of Banks' Assets, BNA BANKING DAILY, June 4, 1999.
agree to indemnify the buyers of the securities if any of the underlying loans go into default. Such clauses, otherwise known as "credit enhancements," make it easier to market securitizations to the investing public.

The problem with recourse clauses is that current regulations do not necessarily require banks to maintain capital that is commensurate to the risks retained. Under U.S. banking regulations, banks must reserve eight cents on the dollar in capital for any commercial loans on their books. If a bank instead takes those loans off its books by securitizing the loans with recourse, it currently must reserve the lesser of eight cents on the dollar or the amount of the bank's maximum contractual exposure under the recourse clause. That is true even if the residual interest that the bank retains under the recourse clause exceeds eight cents on the dollar. If the securitized loans are highly risky (a recent hallmark of bank securitizations of subprime loans in the United States), or if the bank has forfeited servicing rights that would otherwise enable the bank to monitor the loans closely to facilitate prompt repayment, the bank may eventually sustain losses that exceed the capital reserved. Thus, U.S. banks have incentives to engage in securitization with risky recourse provisions because they could boost their capital ratios under federal banking regulations as long as two conditions are met: (1) the banks retain the risk of default through recourse clauses; and (2) the recourse interests exceed eight percent of the value of the securitized pool. The same phenomenon has occurred in Western Europe.

45. An example from regulations proposed by federal banking regulators in the fall of 2000 illustrates the point. Assume that a bank securitizes subprime credit card loans valued at $100 million. In order to market the securities, the bank agrees to accept recourse for up to $15 million of the loans (fifteen percent) in the case any of the loans go into default. Under current federal regulations, the bank only needs to reserve capital against the recourse interest of eight percent, instead of fifteen percent. Capital: Leverage and Risk-Based Capital Guidelines; Capital Adequacy Guidelines; Capital Maintenance; Residual Interests in Asset Securitizations of Other Transfers of Financial Assets, 65 Fed. Reg. 57993, 57996 (Sept. 27, 2000) (to be codified at 12 C.F.R. pts. 3, 208, 225, 325, 567).


In September 2000, federal banking regulators proposed amendments to U.S. capital standards to require insured depository institutions to hold dollar-for-dollar capital for retained recourse interests, even if that capital exceeds the capital an institution otherwise would have
This technique grew so quickly in the United States and Western Europe that "[f]or certain banks," the Basel Committee concluded that securitization was "undoubtedly starting to undermine the comparability and even the meaningfulness of the capital ratios maintained." Because of disparities in the growth of securitization internationally, banks in the United States and Western Europe have been able to avoid maintaining capital commensurate with their risks while gaining an unfair advantage in the application of the Basel capital adequacy standards.

2. Manipulation Of The Risk Weight Categories

The second example of regulatory arbitrage consists of exploitation by banks of the Basel Accord's relatively crude system of weighting risk. Under the 1988 risk-weighted capital system, assets are divided into four broad categories, referred to as "buckets." Each bucket has a different weight, according to its supposed level of risk. The bucket that is deemed the highest risk (consisting of unsecured loans, commercial loans, real estate owned, and loans to non-OECD foreign borrowers and governments) is weighted one hundred percent, while the bucket deemed free of credit risk (consisting of cash, U.S. government obligations, Federal Reserve Bank stock and obligations, and gold bullion) is weighted zero. In between falls the bucket for low-risk assets (such as loans backed by cash deposits, certain government guarantees and government securities), which is weighted twenty percent, joined by the bucket for medium-risk assets (such as loans secured by residential real estate and certain revenue bonds), which is weighted fifty to reserve to retain the entire asset on its books. In addition, the regulators proposed capping residual interests at twenty-five percent of Tier 1 capital in order to prevent over-concentration in the holdings of recourse interests. Capital; Leverage and Risk-Based Capital Guidelines; Capital Adequacy Guidelines; Capital Maintenance; Residual Interests in Asset Securitizations of Other Transfers of Financial Assets, 65 Fed. Reg at 57995-97; see also Risk-Based Capital Standards; Recourse and Direct Credit Substitutes, 65 Fed. Reg. 12320 (Mar. 8, 2000) (to be codified at 12 C.F.R. pts. 3, 208, 225, 325, 567).

47. BASEL ACCORD STUDY, supra note 16, at 4; see also id. at 3-4, 21-27, 45-52; German Banks Under Fire, supra note 21, at 19-20.


percent. To determine how much capital must be held against a particular asset, regulators multiply the weight of the applicable bucket by eight percent. Thus, a loan weighted twenty percent requires the bank to hold capital in the amount of 20 percent times 8 percent, or 1.6 percent of the value of the asset.

The four-bucket system assumes, however, that assets within each bucket have equal risk, when often that is not the case. Commercial loans, for example, are lumped into a single bucket, whether a corporate borrower has a sterling AAA credit rating or is in danger of default. Thus, the system gives banks incentives to shed lower-risk assets for higher-risk assets within each bucket. It is relatively easy to engage in those tactics, moreover, without detection. Due to methodological difficulties, studies attempting to detect that activity have been inconclusive. Nevertheless, there is widespread agreement that the problem exists.

Similarly, the four-bucket system assumes that assets with higher weights have higher risks than lower-weighted assets. That is not always the case. Relatively risky loans to South Korean banks, for instance, require four-fifths less capital than loans to United States companies with AAA credit, simply because South Korea is a member of the OECD. Under the circumstances, the rational choice would be to lend to South Korean banks.

3. Off-balance-sheet Items

The Basel Accord’s treatment of off-balance-sheet items provides a third opportunity for regulatory arbitrage. Under the current Accord, off-balance-sheet items in the form of commitments with an original maturity of one year or less do not require capital, while commitments with a longer maturity are

50. McCoy, supra note 3, ¶ 6.03.


52. E.g., Basle Brush, The Economist, May 1, 1999, at 69; Basel Committee on Banking Supervision, A New Capital Adequacy Framework 26-28, 30, available at http://www.bis.org/publ/index.htm (last modified Feb. 12, 2001) (loans to banks in OECD nations are weighted twenty percent, while loans to corporate borrowers are weighted one hundred percent).
weighted fifty percent. Banks have neatly circumvented this rule by devising "evergreen" commitments with an initial maturity of less than one year that the banks roll over on an annual basis.

4. Divergent Bank Rescue Policies

Finally, opportunities for regulatory arbitrage occur where nations have identical capital adequacy policies but radically different rescue policies for failed banks. Around the world, the bank rescue policies of different nations range from strict market discipline (denying recovery to shareholders of failed banks) to full bailouts for bank shareholders (found in many emerging economies). Those rescue policies have feedback effects that alter the future risk propensity of banks. If a country bails out the shareholders of its banks, the bailout sends signals to shareholders of other banks that they can increase risk-taking with impunity. When capital adequacy rules are uniform from country to country, international banks will have incentives to charter in countries with lax bank rescue policies, because they will not have to reserve additional capital to offset the heightened incentives for risk created by lax bank rescue policies. Moreover, international banks in lax countries that operate abroad through branches rather than through separately incorporated subsidiaries have higher incentives to increase their risk-taking abroad and at home. This is because if the bank becomes insolvent, the generous rescue policies of the lax country will apply to the entire bank corporation, including its overseas branches. Thus, as Viral Acharya recently concluded, "when the rescue policy of one regime becomes more forbearing, the change not only destabilizes the banking sector with the lax

53. BASEL COMMITTEE ON BANKING SUPERVISION, A New Capital Adequacy Framework 32, available at http://www.bis.org/publ/index.htm (last modified Feb. 12, 2001). In addition, commitments of any maturity do not require capital where those commitments can be unconditionally cancelled at any time. Id.

54. Id.

55. In the United States, for example, almost three quarters of failed banks are resolved through assisted mergers with other banks (also known as purchase and assumption agreements), while Finland, Sweden, Norway and Japan rely principally or exclusively on open bank assistance (government bailouts). ACHARYA, supra note 51, at 23-24.

56. Id. at 24-26.

57. Id. at 32, 36-38.
regime but through a systemic effect also destabilizes the banking sector of the stringent regime.\textsuperscript{58}

In sum, while the Basel Committee has moved rapidly toward international prudential standards, the inevitable centrifugal forces that are characteristic of cartels have already reared their head. Cognizant of the Basel Accord's many flaws, the Basel Committee responded in June 1999 by issuing a consultative paper seeking comment on amendments to the Basel Accord. In response to comments, the Committee revised the proposal and issued a massive second consultative paper on January 16, 2001, a complex proposal that together with its supporting documents exceeded 500 pages.\textsuperscript{59} The draft revisions attempt to discourage regulatory arbitrage in loan decisions by proposing two alternative ways in which banks may satisfy their minimum capital requirements as to credit risk. Far from papering over the cracks, however, the Committee's proposal exposed a deep rift in the economic philosophies of the G-10 members.

The Committee's first proposed alternative is called the "standardised approach" and consists of a variation on the four traditional risk-weight buckets. Under the standardised approach, the Basel Committee would expand the number of buckets to six or more. More importantly, the Committee would refine the risk-weight bucket system by tying risk weights to external credit ratings by agencies such as Standard & Poor's instead of to asset type, for loans to commercial banks and corporate borrowers (as well as for securitizations). Risk weights for loans to sovereigns would be tied to published credit scores of export credit agencies.\textsuperscript{60}

The purpose of this new approach is to enlist market discipline by assigning risk weights according to a borrower's actual credit risk as

\textsuperscript{58} Id. at 38.


\textsuperscript{60} The New Basel Capital Accord, supra note 59, at 7, 9-10; A New Capital Adequacy Framework, supra note 59, at 5,13,26-27. In a related vein, the Basel Committee proposed increasing the risk weights of assets and commitments that have proven over time to pose higher risk. Certain higher risk assets would be weighted 150 percent or more. The New Basel Capital Accord, supra note 59, at 11. Similarly, short-term off-balance-sheet commitments would be weighted twenty percent to stem the use of evergreen commitments. Id. at 12.
determined by the market, thereby reducing opportunities for arbitrage.\textsuperscript{61} Under the new system, for example, the risk weight assigned to a corporate loan could vary from twenty percent to over one hundred percent, depending on the borrower's external credit rating.\textsuperscript{62} Similarly, capital charges for asset securitizations would be based on external credit ratings for the underlying issue of securities.\textsuperscript{63}

Under the Committee's second alternative, called the "internal ratings based" or "IRB" approach, sophisticated international banks would be permitted to calculate their capital according to their own internal assessments of credit risk instead of the standard risk-weight buckets. As proposed, the IRB approach would have two tracks: the foundation approach and the advanced approach. Under the foundation approach, strong banks that met certain prerequisites could use their own estimates of probabilities of default for individual borrowers. Regulators would then estimate the likely losses upon default, exposure at default and effective maturities to come up with risk weights. Under the advanced approach, banks meeting the strictest safety and soundness standards would be allowed to use their own estimates of loss upon default, exposure at default and effective maturities (in addition to probabilities of default), instead of those furnished by regulators.

The Committee gave three purposes for the IRB approach. First, the Committee sought to capitalize on the fact that banks are usually better informed about their borrowers than credit rating agencies or regulators (because, among other things, banks can monitor borrowers' financial

\textsuperscript{61} As one commentator has noted, however, if the Committee does not expand the number of rating buckets beyond six, serious arbitrage incentives will remain. See João A.C. Santos, Bank Capital Regulation in Contemporary Banking Theory: A Review of the Literature 19 (Bank for International Settlements, BIS Working Paper No. 90, Sept. 2000), available at http://www.bis.org/publ/work.htm (last visited April 21, 2001).


\textsuperscript{63} The New Basel Capital Accord, supra note 59, at 89; A New Capital Adequacy Framework, supra note 59, at 36-37. U.S. regulators have proposed a similar approach. Risk-Based Capital Standards; Recourse and Direct Credit Substitutes, 65 Fed. Reg. 12320 (Mar. 8, 2000) (to be codified at 12 C.F.R. pts. 3, 208, 225, 325, 567). In addition, U.S. regulators have proposed superimposing a dollar-for-dollar capital charge for all retained recourse interests. See supra note 46; Capital; Leverage and Risk-Based Capital Guidelines; Capital Adequacy Guidelines; Capital Maintenance; Residual Interests in Asset Securitizations of Other Transfers of Financial Assets, 65 Fed. Reg. 57993, 57997-98 (Sept. 27, 2000). It is not yet clear how the two approaches would be harmonized. Id. at 57998-99.
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movements through their checking accounts). In addition, the proposal seeks to harness the natural incentives of most large banks to avoid undue losses. Finally, the Committee was responding to criticisms, particularly by banks, about the drawbacks of the "one size fits all" approach that was implicit in the original 1988 Basel Accord.  

Despite the surface appeal of both proposals, they have been embroiled in controversy from the outset. In response to the proposed revisions, the same cartel forces surfaced that undermined the original 1988 accord. The fault lines, moreover, fall along the traditional divide between market systems and block-holding systems. As this history suggests, the problems of enforcement that are inherent in any cartel may be even more intractable in the case of the Basel Accord because the disagreements reflect incompatible differences in economic structures and norms. The first example involves the proposal to link risk-weight categories to external credit ratings. External credit rating agencies are primarily an incident of the U.S. market system and specifically of capital markets, which require transparency and disclosure in order to work. In the rest of the world, which is mostly characterized by block-holding systems, external credit rating services are scant or simply not in place. Rating services have not taken root in block-holding systems because capital markets in those countries are weak (reducing the need for external ratings) and the control stakes by banks that are typical of those systems have traditionally been the substitute for the data that credit agencies provide. Thus, it comes as no surprise that the three

64. A New Capital Adequacy Framework, supra note 59, at 5-6, 13-14, 37-41. For a description of the committee’s two approaches see The New Basel Capital Accord, supra note 59, at 32-86.


Even in market systems such as the United States, external credit rating systems are not a panacea because corporate borrowers are not always externally rated. (As this suggests, to some extent credit rating agencies and banks serve different segments of borrowers). See BNA BANKING DAILY, June 9, 1999; A New Capital Adequacy Framework, supra note 59, at 27. For a survey of credit rating systems generally, see CREDIT RATINGS AND COMPLEMENTARY SOURCES OF CREDIT QUALITY INFORMATION (Basel Comm. on Banking Supervision, Working Paper No. 3, Aug. 2000), available at http://www.bis.org/publ/index.htm.
main credit rating systems that the Basel Committee looks to as models are Standard & Poor's, Moody's Investor Service, Fitch IBCA and Duff & Phelps, all of which are based in the United States.66

The effect of using external credit rating systems, as conceived by the Basel Committee, moreover, would often be to favor rated borrowers over unrated borrowers. Thus, corporate borrowers with ratings of "the very highest quality" would receive favorable risk weights of twenty or fifty percent,67 while most other corporate loans (including unrated loans) would continue to receive the one hundred percent weight that is customary under the current system.68 Since external credit ratings are most prevalent in the United States, U.S. banks would thus be positioned to obtain preferential capital treatment over their overseas competitors.

Under the circumstances, the backlash that ensued69 was understandable. On the surface, the external credit rating proposal was viewed in Western Europe and elsewhere as an attempt by U.S. regulators and banks to use their unique informational advantages to win lower capital ratios for the United States. Furthermore, those advantages are not necessarily transitory. To the contrary, those advantages are likely to persist so long as capital markets for corporate debt offerings remain weaker in block-holding countries than in the United States and Britain. Alternatively, block-holding countries could subvert the system, either by encouraging the formation of new competitors


68. Id. This is not to say that rated borrowers would invariably receive preferential treatment. At a minimum, borrowers with lower ratings would continue to receive risk weights of 100 percent. Indeed, under the Basel Committee's proposed scenario, it is possible that a rated borrower with a poor rating would be weighted 150 percent and thus be treated more harshly than unrated borrowers, who would be weighted 100 percent. See id.; Growing Basle, supra note 44, at 69-70; Bank Rules in Disarray, supra note 21, at 75. To that extent, banks that lend to unrated borrowers would have the same opportunity as previously to exploit the risk-weight buckets to their advantage.

69. See, e.g., Bank Rules in Disarray, supra note 21, at 75; Basle Brush, supra note 52, at 69.
to Standard & Poor's, Moody's and Fitch IBCA, with the attendant danger of grade inflation, or by permitting weaker banks to switch to the IRB system. Either way, the overriding goals of capital adequacy—i.e., competitive parity and safeguards against systemic risk—would be disserved.

Market and block-holding systems also split over the Committee's alternative proposal to permit sophisticated banks to use their own internal credit risk assessments in lieu of external ratings. Once again, the United States and specifically American banks were the major proponents of the IRB approach. Major banks in block-holding systems (most visibly Germany) had barely any experience with internal credit rating systems. Until the Basel Accord revisions were proposed, those banks did not need to resort to well-developed internal systems, because they used their equity stakes in corporate borrowers to monitor credit risks. Once again, as with the case of external credit ratings, the IRB standard largely favors U.S. banks, to the detriment of their overseas competitors.
B. DIVERGENT EFFICIENCY NORMS IN MARKET AND BLOCK-HOLDING SYSTEMS

As the problems enforcing the Basel Accord indicate, there is an even more fundamental source of instability in the Basel Committee's edicts, arising from the inherent problems in forcing a single, culturally dependent template of efficiency over banking systems at different stages of development and with fundamentally different needs and norms. The sit-ins and the riots at the 1999 negotiations of the World Trade Organization in Seattle were testament to the growing backlash against the muscle of Western multinational corporations, Western governments and international financial institutions. Increasingly, the Basel Committee's initiatives may be vulnerable to similar opposition.

In the final portion of this article, I would like to explore this problem as it applies to varying efficiency norms in patterns of bank lending. Previously I spoke about the information asymmetry between depositors and banks. Banks suffer from information asymmetries of their own with respect to borrowers. When banks extend credit, they do not know with perfect assurance that the loan will be repaid in a timely manner and in full. Every economy has methods for attempting to redress that asymmetry. Those methods, however, can vary depending on a variety of factors, including the economy's stage of development and business norms. Mature capitalist economies have the greatest latitude in that regard, because of the richness and stability of their monitoring mechanisms. Thus, banks in mature economies can depend on courts to enforce collateral and notes, may have access to credit rating services, can analyze the borrower's likelihood of repayment through desktop underwriting models that have been actuarially

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Financial Regulatory Committee, supra, at 1, 4; BNA Banking Daily, June 9, 1999; Santos, supra note 61, at 19 n.46. Today, major banks use a variety of internal rating systems, ranging from those "focused on the judgement of expert personnel" to "those based solely on statistical models." Range of Practice in Banks' Internal Ratings Systems, supra, at 4, 17. A Basel Committee report recently found potentially significant inconsistencies in the data sources reviewed by banks, the definitions and tools used to measure that data, and the conclusions as to risk that were drawn. See id. at 4, 10, 14, 16, 42.

73. See, e.g., Financial Standards—Indian Understanding, Financial Times Information, March 22, 2001. Professor Douglas M. Branson has recently discussed this problem as it pertains to global convergence in corporate governance. See Branson, supra note 1.

tested and can monitor the borrower's financial status through computerized loan reports.

In block-holding systems such as Germany's, banks also monitor borrowers through equity stakes and direct representation on the borrower's board (something that is banned in the United States). This form of lending, which I will call "connected lending," is one of the hallmarks that distinguishes block-holding systems from their market system counterparts. In block-holding systems, connected lending of one form or another is considered integral to both banking and corporate governance and, as such, is legally sanctioned. Conversely, in market systems such as the United States, connected lending is heavily regulated and strongly discouraged. Instead, in the United States, arms' length terms are an overriding norm in lending. Connected lending is frowned upon, in part because of concerns that cozy relationships might impair underwriting judgments and also because financing might dry up for new entrepreneurial ventures. In contrast, the German system views preferential treatment of connected borrowers as beneficial on balance, because of the informational advantages of ongoing membership on the borrower's board, the bank's pivotal role in monitoring corporate governance and the long-term horizon of investment. Weak protections for minority shareholders in block-holding systems such as Germany's, moreover, mean that if the interest rate or the prospects for return are suboptimal, banks may seek to augment low returns through other means, such as interested transactions, insider trading or higher interest charges over the long term.

These differences become even starker in emerging economies. Unlike their wealthier neighbors, many emerging economies have little choice except to embrace connected lending to a greater or lesser degree. In those nations, little of the infrastructure is in place that would allow banks to bridge the natural information gaps with unfamiliar loan applicants. In economies where the rule of law is weak and force is the rule, where credit reporting systems have not taken root, where social trust is frayed and inflation is


76. See McCoy, supra note 3, § 6.04[2].


78. See, e.g., Bratton & McCahery, supra note 1, at 267-68; Rajan & Zingales, supra note 4, at 40, 42-43.
rampant, banks will generally restrict their lending to individuals and businesses whom they know and trust.\textsuperscript{79}

In the abstract, connected lending of this sort may not be optimally efficient. Price signals are weaker in block-holding systems than in systems favoring arms' length lending.\textsuperscript{80} In addition, connected lending often diverts capital from more efficient uses and is conducive to kickbacks at its worst. Obviously, the grosser forms of connected lending are signs of underlying pathology. Examples include extensions of credit where repayment is known to be unlikely or where the borrower's management in effect controls the lending decisions of the bank. But where blatant misconduct such as looting of the bank is not involved and the bank is acting in good faith, connected lending may be the best that banks can do in a bad situation, until some later date when the legal and information infrastructures are in place. In more mature economies such as Germany or Japan, where connected lending is not strictly a function of an economy's stage of development, it nevertheless may be integral due to other tradeoffs, such as the importance of banks as corporate monitors.

Nevertheless, when we examine Principle 10 of the Basel Committee's Core Principles, we see the admonition, characteristic of market systems, that "[c]onnected lending . . . can lead to preferential treatment in lending and thus greater risk of loan losses."\textsuperscript{81} Trying to force block-holding systems to abandon connected lending altogether and apply an arms' length model patterned after loans to strangers may ultimately cause more harm than good. Banks may simply steer clear of the well and withhold private extensions of credit altogether, instead shifting their investments to government securities. In transition economies, if banks do lend to strangers, they well might lose their shirt, increasing the risks of bank runs and losses to small depositors. That, in turn, can retard the growth of domestic banks by leading to domination by foreign banks.\textsuperscript{82} Finally, in countries such as Germany where banks are important monitors of corporations, proscriptions against connected lending to related borrowers could have serious adverse consequences for imbedded norms of corporate governance.

\textsuperscript{79} See, e.g., Bratton & McCahery, \textit{supra} note 1, at 227 nn.41-42; Rajan & Zingales, \textit{supra} note 4, at 41.

\textsuperscript{80} See Rajan & Zingales, \textit{supra} note 4, at 43-44.

\textsuperscript{81} \textit{Core Principles}, \textit{supra} note 19, at 20.

\textsuperscript{82} See, e.g., Terrill, \textit{supra} note 38, at 280.
CONCLUSION

In conclusion, the Basel Committee needs to tread cautiously if these deep-seated sources of incompatibility are not to undermine consensus. At a minimum, the juggernaut toward global harmonization in banking could well engender experiences such as Russia's, where the Basel Committee's standards have been honored in the breach as often as not. At the worst, its pronouncements could lead to calls to storm the barricades, similar to what occurred in Seattle, and most recently in Genoa, if the Committee's lack of political accountability and legitimacy came to a head. If the Basel Committee continues to ignore these concerns, it will do so at its peril.