Global Bank Regulation
Dedications:

For Pete, Steve, Thor and John (H.M.S.)

For J.B., as always (M.W.T.)

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# Contents

*Introduction: The Global Financial System and the Problems of Regulation* xi

1. **The Changing Nature of Banks**  
   Definitions 2  
   Money, Credit Creation, and Fractional Reserve Banking 3  
   Financial Innovation and the Changing Nature of Banks 7  
   Three Distinctive Features of Modern Banking 11  
   References 17  
   Further Reading 17

2. **Panics, Bank Runs, and Coordination Problems**  
   The Structure of Banks’ Balance Sheets 20  
   Coordination Problems and Bank Runs 24  
   Panic and Contagion in Modern Financial Systems 27  
   Free Riders and Regulation 32  
   References 34  
   Further Reading 34

3. **Collapsing Dominos and Asset Price Spirals**  
   Collapsing Dominos 36  
   Asset Price Spirals 42  
   The Global Financial Crisis of 2007–2009 45  
   References 49  
   Further Reading 49

4. **The Financial Safety Net and Moral Hazard**  
   The Financial Safety Net 53  
   Moral Hazard 60  
   Is There an Alternative? 67  
   References 70  
   Further Reading 72
<table>
<thead>
<tr>
<th>Chapter</th>
<th>Title</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>15.</td>
<td>Institutional Structures of Regulation</td>
<td>259</td>
</tr>
<tr>
<td></td>
<td>Institutional and Functional Regulation</td>
<td>260</td>
</tr>
<tr>
<td></td>
<td>Rise of the Integrated Regulator</td>
<td>265</td>
</tr>
<tr>
<td></td>
<td>Twin Peaks (Objectives) Approach</td>
<td>267</td>
</tr>
<tr>
<td></td>
<td>Role of the Central Bank in Bank Supervision</td>
<td>269</td>
</tr>
<tr>
<td></td>
<td>Evaluation of Structural Reforms</td>
<td>273</td>
</tr>
<tr>
<td></td>
<td>References</td>
<td>276</td>
</tr>
<tr>
<td></td>
<td>Further Reading</td>
<td>277</td>
</tr>
<tr>
<td>16.</td>
<td>Regulation After the Global Financial Crisis</td>
<td>279</td>
</tr>
<tr>
<td></td>
<td>The Causes of the Crisis</td>
<td>280</td>
</tr>
<tr>
<td></td>
<td>Rethinking the Assumptions of Regulation</td>
<td>284</td>
</tr>
<tr>
<td></td>
<td>New Directions in Capital Adequacy</td>
<td>286</td>
</tr>
<tr>
<td></td>
<td>More Radical Options</td>
<td>289</td>
</tr>
<tr>
<td></td>
<td>The International Dimension</td>
<td>292</td>
</tr>
<tr>
<td></td>
<td>References</td>
<td>294</td>
</tr>
</tbody>
</table>

*Appendix A: Introduction to Regulation and Market Failure* 297

*Subject Index* 307
We've decided to write off 47 billion dollars in bad loans.

You might think this is my fault, but in actuality it is all caused by poor regulatory oversight.

Who is in favor of those guys taking a big pay cut? Anyone?
Introduction:
The Global Financial System and the Problems of Regulation

This book examines the principles, policy, and law relating to the regulation of international banking. Other regulation textbooks focus on the laws and regulations of one particular country, be it the United States or Britain or some other important banking center. This approach is understandable, since regulations have traditionally been made and applied at the national level. Nonetheless, during the past 30 years, financial systems, markets, and institutions turned global. Each of the leading international banks now operates in dozens of countries and is therefore subject to oversight by dozens of regulatory agencies. Nationally based regulators, in the most developed and in developing countries, have adapted to the new realities of the global financial system through new forms of cooperation and coordination, with international standard-setting bodies forming the core of this response. We believe these developments are fundamental to the understanding and teaching of bank regulation.

Although the government agencies responsible for regulating global markets and institutions remain rooted in national legal systems, they have increasingly sought convergence of their rules and regulations. European Union countries have agreed on common minimum standards and oblige their national regulators (through international treaty) with implementation. In the rest of the world, convergence on minimum standards centers on soft law, with informal international groupings of regulators seeking compliance with their standards through force of example and other forms of moral suasion. The most important such group is the Basel Committee on Banking Supervision (Basel Committee or BCBS), a body that brings together central banks and regulatory agencies from North and South America, Europe, and Asia.

International standards set by bodies like the BCBS and the European Union are the main focus of this book. These standards bridge the gulf between domain (the geographical area over which financial institutions and markets operate) and jurisdiction (the machinery of legislation and regulation that ensures the orderly operation of markets).¹ The fact that the regulatory system remains fragmented along

¹These terms were first used to describe the disconnect between global markets and the arrangements for their governance by the economist Richard N. Cooper in his 1968 book The Economics of Interdependence.
national lines while financial institutions operate far beyond the borders of their home countries remains a significant and persistent challenge to regulatory policy. The Global Financial Crisis that began in the summer of 2007 made this issue one of more than mere theoretical relevance.

In this introduction, we begin with a broad overview of the aims and purposes of banking regulation and then discuss how the development of a global financial system complicates the task of regulating firms with border-crossing operations. The fundamental problem is how to ensure adequate supervision of a firm that operates in many different countries, across all time zones. We follow with a brief discussion of the policy networks, including bodies like the BCBS, which assist regulators with this global challenge. The output of these networks, in the form of international standards and agreements, is the main focus of this book. Finally, we end with a brief overview of the book’s structure and how it might be used in teaching courses on the regulation of international banking.

**The Rationale for Regulation**

Bank regulation is concerned primarily with ensuring that banks are financially sound and well managed. In the United States, this concept is referred to as safety and soundness regulation and in most of the rest of the world as prudential regulation. Although banks are subject to many other forms of regulation, including consumer and investor protection requirements, these regulations receive only our passing attention. The focus of this book is on prudential regulation, and we therefore begin with an explanation of why governments subject banks to prudential regulation.

Governments intervene in the operation of a market economy, whether through taxation or through regulation, for two primary reasons: either to ensure that markets work efficiently or to alter market outcomes to achieve social objectives. With only a few exceptions, tax policy is most often used to achieve social objectives. For example, a tax on the wealthy can be used to redistribute wealth to those less fortunate through welfare programs. On the other hand, the general objective of regulation is market efficiency. Since economists usually refer to market inefficiencies as market failures, regulation is often described as an attempt to correct a market failure.

Conventional economic theory recognizes three market failures that generally form the basis for regulatory intervention. The first is the existence of monopoly

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2The United States’ Community Reinvestment Act (CRA), 12 U.S.C. §§ 2901–2906, is an example of a regulation created to achieve social objectives. The purpose of the CRA is to encourage banks to meet the credit needs of local communities, especially low income areas.
power. If one or a few firms have the power to restrict competition, they are likely to raise prices, restrict supply, offer poorer service, and restrict innovation. The distortion of the market through the exercise of monopoly power supports anti-monopoly and anti-cartel legislation as far back as the United States’ Sherman Antitrust Act (1890) and as recent as the United Kingdom’s Competition Act 1998.

The second way in which markets can fail is through the existence of externalities or what are sometimes referred to as spillover costs. These arise when the economic activities of some participants in a market indirectly affect, positively or negatively, the well-being of others. Positive externalities arise in a wide variety of contexts. For example, a popular restaurant that brings customers to nearby businesses is not compensated for the value of the positive externality it generates. Regulation, however, is typically employed to correct negative, rather than positive, externalities. A negative externality exists when the price of a good does not reflect the true cost to society of producing that good. In the classic example, if a steam train emits sparks that occasionally burn the crops of nearby farmers, the cost of the destroyed crops is a spillover cost (externality) imposed on the farmers by those who use the train. To account for this externality, either the users of the train could be taxed to compensate the farmers or the emission of sparks from a railway locomotive could be regulated, for example, by setting standards for the construction of locomotive chimneys.

The third justification for regulation arises from the existence of information imbalances (“asymmetries”). In a well-functioning market, buyers and sellers possess all the information needed to evaluate competing products or services. Buyers and sellers must be able to identify the alternatives available and understand the characteristics of the goods or services offered. Yet, information is a commodity like any other, and markets for information can fail like any other. For example, one of the parties to a transaction may deliberately seek to mislead the other, by conveying false information or failing to disclose key facts. Failures in the market for information justify regulation of various types—for example, food labeling or disclosures in securities offerings.

### The Regulation of Financial Institutions and Markets

Regulation over the past three decades has rested on the notion that markets are essentially rational and highly efficient at allocating resources and that markets are generally self-policing and self-correcting. Given these assumptions, regulatory

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3 See the appendix for a more extensive discussion of externalities.

4 See the appendix for further discussion of information asymmetry.
intervention could be justified only to the extent necessary to correct the comparatively rare instances in which markets may fail. In the context of banking, these market failures take two main forms: information asymmetry and systemic risk (a negative externality). Most of the regulations examined in this book represent attempts to correct these two types of market failure.

**INFORMATION ASYMMETRIES**

In the first place, the justification for the regulation of financial institutions and markets arises from the existence of information asymmetries. Information asymmetries are common in many product markets. Many products are complex, are difficult to understand and compare, or involve a substantial investment (e.g., the purchase of a car). What makes financial products different is not the existence of these characteristics, but their nature and intensity. The essence of a financial contract is a promise that money placed in an investment today will be paid back in the future. This contract exists between a depositor and a bank; a policyholder and insurance company; an investor and a mutual fund.

With the bank deposit, the bank promises to return the depositor’s money, with the contractual interest, anytime the depositor demands it (as with a checking account) or at some future date (as with a certificate of deposit). The bank, however, is in a much better position than its depositors to judge the bank’s ability or intention to make good its promise. In the most extreme case, a bank might take deposits that it has no intention of honoring (this happened with the Bank of Credit and Commerce International, a case we study in Chapter 12). Similarly, the depositors’ funds might be used for the benefit of the owners of the firm or to offer higher returns to other depositors (as happens, for example, with Ponzi schemes\(^5\)). However, even an honest bank may, through poor management or bad judgment, fail to honor its promises, causing depositor losses.

While a depositor should assess the quality of the product offered (i.e., a promise by the bank to repay the deposit, plus an agreed rate of interest), the quality of a bank deposit depends on the financial soundness of the depository bank. The asymmetric information between the bank and its depositor leaves the depositor unable to judge the bank’s financial condition. This not only increases risk to the depositor, but also makes it difficult for a solvent, well-managed bank to convey credibly the reliability of its promise. The result is Akerlof’s market for lemons, discussed in the appendix.

\(^5\)A Ponzi scheme is a fraudulent investment in which investment returns are funded by new investors rather than actual profits. The technique derives its name from Charles Ponzi, who was notorious for employing such a scheme in the early 1920s.
Depositors and other bank creditors suffer from an information asymmetry that stems from the nature of a bank’s assets. Loans that banks make to individuals and business borrowers comprise the traditional bank asset. Yet, it is very difficult for those outside the bank to evaluate these loan assets. The reason is that banks have access to information about their borrowers that is not available to others, including the bank’s depositors and potential depositors. Thus, a bank’s depositors and other creditors have difficulty assessing a bank’s solvency because they cannot independently verify the value of a bank’s assets. When depositors and other creditors have difficulty verifying the bank’s solvency, they cannot be assured that the bank will live up to its promise to pay.

Even if information is available, most bank depositors lack the technical expertise to evaluate the information given, just as airline passengers are unable to assess a plane’s airworthiness even if they are given all the key technical specifications regarding the aircraft. Moreover, even with the requisite technical expertise, the value of a bank’s assets can be very difficult for a third party (i.e., someone who is neither the bank nor its borrower) to assess. In response to this problem, some economists have favored market value accounting for banks, which would force banks to value their assets at their current market price. But the majority of bank assets (i.e., loans) do not have a ready market, and thus assigning them a market price is highly speculative.

The existence of asymmetric information also gives rise to the problem of adverse selection. Adverse selection is an asymmetric information problem that occurs when the parties who are most likely to produce an undesirable (adverse) outcome are the ones most likely to be selected. Adverse selection affects the ability of the market mechanism to match up feasible trades, i.e., trades that both buyer and seller would be willing to undertake if doubts about quality were removed. In some cases, adverse selection can prevent the emergence of a market altogether.

In an unregulated banking system, depositors are likely to confront an adverse selection problem. The value of a bank deposit depends heavily on the honesty, probity, and competence of the bank itself, and these are qualities that are difficult for most customers to judge. If bank depositors are doubtful about the honesty of bankers, they will demand high interest rates to compensate themselves for the risk that their deposit will never be repaid. But honest bankers will find it difficult to generate the kinds of returns that would enable them to pay depositors such high interest rates. Therefore, the only people who will promise depositors high rates of return are those who make their promises fraudulently. Either depositors will recognize the unrealistic promises of gain and take their business elsewhere, or they will be attracted by the promises of high returns and place their money in the hands of fraudsters. By the time the bank’s promises are exposed as fraudulent, most depositors will have already lost their savings.

To minimize the risks to depositors, many governments around the world provide—either implicitly or explicitly—some form of guarantee or insurance in the
event that a financial intermediary fails to meet its obligations. Thus, deposits with a bank are guaranteed by deposit insurance programs (outside the United States, such programs are often referred to as deposit insurance schemes) up to a certain maximum. Similar government-sponsored programs protect insurance policyholders from the risk of failure of their insurance company.

When governments offer such guaranties, they do so with strings attached. Governments regulate the firms whose solvency is being insured to limit the potential claims on the various compensation schemes. This forms much of the justification for regulation of insurance companies, and is also an important rationale for the regulation of banks. For example, government sponsored deposit insurance justifies the requirement that banks be licensed, that their management be fit and proper, and that the banks are run in accordance with regulatory mandated minimum levels of capital and liquid assets.

**SYSTEMIC RISK**

By their nature, financial contracts involve promises to make future payments at specified times, in specified amounts, and in specified circumstances. The more sophisticated the economy, the greater its dependence on financial contracts and the greater its vulnerability to the failure of the financial system to fulfill its contracts. The indispensable role of finance in a modern economic system and the potential for financial failure to lead to systemic instability introduce an overarching externality that can impose significant costs both in terms of the level of economic output and government revenues.

Systemic instability is defined in a variety of ways, but in general arises when financial distress in one financial institution is communicated to other institutions. Such contagious distress may occur when problems in one institution trigger a crisis of customer confidence in other institutions. Alternatively, the failure of one institution to settle its obligations may cause the failure of other, fundamentally sound, institutions. Traditionally, banks (i.e., deposit-taking institutions) were considered uniquely susceptible to this type of contagion. Banks' susceptibility to financial crisis stems from the precarious nature of the financial service they provide, which transforms illiquid assets (loans) into liquid liabilities (deposits). A bank’s commitments can be met in normal times because customers’ demand for access to their deposits is reasonably predictable and banks hold liquid assets to meet this demand. However, when a sufficiently large number of depositors demand their funds simultaneously, the bank’s commitments cannot be met without some form of outside assistance. Since all banks suffer from the same potential weakness, and depositors have difficulty distinguishing between a sound bank and an unsound one, a crisis of confidence in one bank can quickly spread to others. Further, a mere concern about
a bank’s insolvency, whether or not well founded, may be sufficient to actually cause insolvency if the bank’s assets have to be liquidated at reduced,iresale prices to meet the demands of withdrawing depositors.

A further source of contagion among banks is that they participate in the payments system, through which obligations are settled between financial intermediaries. The failure of one participant in that system to meet its obligations can impede the ability of other participants to meet their own obligations. Disruption to the payments system can in turn precipitate a wider economic crisis. Arguably, the core of the payments system poses the greatest systemic risk.

Systemic risk is costly both in terms of lost economic output and the public funds spent in bailing out banks. According to a survey conducted by a team of the International Monetary Fund (IMF), between 1980 and 1996, 133 out of 181 IMF members suffered either “significant problems” or a “crisis” in their banking sectors. During this period there were 41 identified crises in 36 countries (Lindgren et al., 1996, p. 20). The effect on the real economies and on the fiscal systems of those countries experiencing banking crises was generally severe. In the United States, the cost of resolving the savings and loan crisis of the late 1980s was roughly 5.1% of GDP. According to the IMF, the costs of restructuring banking systems as the result of banking crises have varied from 4.5% of GDP in Norway and Sweden in 1991 to 19.6% of GDP in Chile in 1985. Given the substantial costs associated with a systemic crisis, regulation throughout much of the world for the last 100 years has focused on the prevention of such crises.

The Case for International Regulation

Concerns over systemic risk dominate international bank regulation. The BCBS’s statement of best practices for bank regulation, the Core Principles for Effective Banking Supervision (“Core Principles”), explains its purpose in terms of the potential for “[w]eaknesses in the banking system of a country … [to] threaten financial stability both within that country and internationally” (Basel Committee on Banking Supervision, 2006, p. 2). In other words, the primary concern of international bank regulation is avoiding spillover of banking problems from one country to another.

Spillovers from one national banking system to another can occur both directly and indirectly. Direct spillovers occur when a bank headquartered in one jurisdiction has significant operations in other jurisdictions. If this bank’s solvency suffers, depositors in all the jurisdictions in which it operates can be adversely affected. Therefore, bank regulators require rules for deciding which of them should take responsibility for regulating banks with significant border-crossing operations to ensure that these banks are always subject to effective supervision. Effective international regulation also requires that all countries apply broadly equivalent
prudential requirements so that a bank operating from one jurisdiction is not signifi-
cantly less regulated than banks operating from other jurisdictions. A bank that bases
its operations in a jurisdiction offering light regulation can pose significant risk
in the other jurisdictions through the bank’s cross-border operations. Moreover, the
lightly regulated bank puts more rigorously regulated banks at a competitive
disadvantage.6

Another form of direct spillover derives from the international payments system
and is illustrated most clearly by the closure of Bankhaus Herstatt in 1974 (see
Chapter 3). Payment systems risks are increasingly internationalized, as are other
linkages between banks, especially in the interbank market. One of the root causes
of the 1997–1998 Asian crisis was short-term lending by developed-world com-
cmercial banks to poorly supervised Asian banks. The withdrawal of this funding was
the cause of severe liquidity problems in several Asian banking systems. In today’s
market-based financial system, banks are also more likely to be the purchasers of
assets originated in other jurisdictions. In the Global Financial Crisis (2008–2009),
European banks’ initial heavy losses were caused by their exposure to securities
backed by subprime mortgages in the United States. These losses in turn constricted
European banks’ ability to make new loans, causing an economic recession, and
leading to a new round of loan losses as their own borrowers defaulted.

Spillovers may occur indirectly through a variety of channels. In a global media
environment, panic in one country can soon spread to another. One of the most
significant indirect channels of financial crises is what is known as contagion. In
today’s globalized financial system, problems that develop in one country can be
rapidly transmitted to others if international investors perceive that investing in two
different countries involves broadly similar risks. Examples are numerous. In 2009,
the banking systems of all the countries of Central and Eastern Europe suffered
from capital flight and deposit withdrawals, even though only a few of the countries
had significant problems in their banking systems. Ten years earlier, the countries
of East and Southeast Asia suffered from a similar phenomenon. Even earlier in
economic history, in 1931, Central Europe also suffered from contagion effects.
These contagion effects can become self-fulfilling prophecies, as the very act of
withdrawing deposits from one country’s banking system can cause its banks to
collapse.

The benefits of high standards of bank regulation are felt not only by the countries
that make such standards a priority. Financial stability is what economists call a
global public good in which all countries benefit from financial stability, whether
or not they contribute to it. The recognition of spillover effects is an important

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6Of course, an alternative approach would be to exclude banks from lightly regulated jurisdictions from
operating in those jurisdictions with more rigorous regulation. This approach, however, is generally
regarded as excessively protectionist.
motivation behind the BCBS’s push for universal adoption of the *Core Principles*. These interlinkages provide strong incentives for bank regulators to ensure that all countries responsible for licensing and supervising banks adhere to a set of common minimum standards, such as the standards discussed in this book.

**COMPETITIVE EQUALITY**

A subsidiary issue that arises in the international context is the question of competitive equality.\(^7\) If institutions regulated in different jurisdictions are subject to different prudential requirements, then some of them may enjoy a competitive advantage. For example, if one regulator requires its banks to hold $8 of capital for every $100 in loans that it makes, and another regulator only requires its banks to hold $4 of capital for the same volume of loans, it is clear that banks from the second country will be at an advantage. Since they are required to hold less capital against their loans, their costs will be lower and they will be able to make loans at a lower price (interest rate). Thus, banks with a high capital requirement will be disadvantaged in competing against banks with a lower capital requirement.

Given the very real possibility that a nation’s regulations or policies could put its institutions at a competitive disadvantage globally, policy-makers may respond by changing their regulations or policies. This willingness to change national regulations in response to the regulations of other countries can be viewed as a competitive process. In the case of bank regulations, regulators from different nations compete with one another as providers of regulatory services. As explained by Kane (1987, p. 119), “financial analysis has focused traditionally on competition for customers by those who produce and distribute financial services. But running parallel to this competition between private financial institutions is a less-visible layer of competition for rights to produce and deliver regulatory services to [f]inancial institutions.” While financial institutions compete on the basis of the price of their services, financial regulators compete on the basis of a *net regulatory burden* (NRB). The NRB is composed of both costs and benefits. Imposing capital requirements on banks’ activity is an example of a regulatory cost. A central bank’s support of the payment system is an example of a regulatory benefit. The combination of the aggregate costs and benefits produces an NRB for each country. Thus, a country with an NRB that

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\(^7\)The notion of competitive equality is, however, important at the national level in the United States. The United States maintains an internationally unique dual banking system in which both states and the federal government authorize and regulate banks. This means that U.S. lawmakers are often faced with claims that either the state or federal system provides a competitive advantage or disadvantage over the other.
is higher than other countries’ will, in theory, place its constituent banks at a competitive disadvantage.

The key policy question regarding differences in countries’ NRB is whether such differences lead to a competitive process that causes countries to change the nature of their regulations to lower the NRB. If this is true, then one might observe an overall convergence of NRBs toward some point of equilibrium (which would be the natural course of events in a typical competitive market). Policy convergence can be observed following the New York Stock Exchange’s decision to abandon fixed commissions on May 1, 1975 (known as May Day on Wall Street). The NYSE’s move prompted a series of deregulatory measures in London, Tokyo, Toronto, and Paris. This provides a clear example of a case in which competition in rules promotes a process in which regulations of different countries converge, i.e., countries begin to adopt the same or similar rules.

The problem with this analysis is that there can be both a good and a bad equilibrium. Many regulators worry that competition among regulators results in a race to the bottom in which regulatory standards fall to the lowest common denominator. They point to the Delaware phenomenon in U.S. corporate law as a prime example. If some jurisdictions in effect undercut their competitors by offering a lower net regulatory burden, then they will force other jurisdictions to follow suit. Otherwise, business will flow out of more regulated countries to the most lightly regulated countries. While this competitive process can prove beneficial in that it forces regulators to do away with unnecessary or ill-thought-out regulations, it can also have costly implications. In a world of open international markets, lightly regulated banks could transmit their deficiencies around the world, causing serious spillover effects and imposing serious costs on jurisdictions that maintain higher regulatory standards. Therefore, competition among regulators cannot be allowed to reach the point where minimum standards fall below levels necessary to preserve international financial stability.

The emergence of international standard-setting bodies, such as the BCBS, responded to this problem. In effect, these bodies set the minimum standards that their members agree to meet to prevent a race to the bottom. Member countries can apply higher standards than those that have been internationally agreed, but none of

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8 In the United States, corporations can be chartered by any of the 50 states (banks can also choose to be chartered by the federal government). Thus, states compete for corporate charters to gain the fees and other associated economic benefits. Delaware has been the driving force in this competition among the states. Critics complain that Delaware has adopted exceedingly management-friendly laws to attract corporate managers while shareholder rights have suffered. As a result, the majority of U.S. corporations are chartered in Delaware. While the Delaware phenomenon has its critics, some praise the competitive process as one that has produced a state with a high level of expertise in corporate law. The Delaware corporate statutes and the state’s judicial opinions are read and studied around the world.
them should apply a lower standard. Such cooperation produced some of the most significant convergence in regulation, e.g., the Basel Capital Accord, over the past several decades. Schooner and Taylor (1999, p. 598) describe the work of international standard setters as “‘negotiated convergence’ because the outcome is derived from extensive negotiation between different national authorities and involves the usual compromises and trade-offs inherent in bargaining.”

### Who Sets the Standards?

Since the mid-1970s, central bankers and bank regulators have recognized the risks presented by an internationally integrated global financial system and the need for international coordination and cooperation. The BCBS has provided the most high-profile and internationally respected response to these problems. The BCBS, which we discuss further in Chapter 5, is an example of what international relations theorists call a *policy network*. The policy network concept originated in what Robert Keohane and Joseph Nye (2000, p. 344) term “transgovernmental” activity, which they defined as “sets of direct interactions among sub-units of different governments that are not controlled or closely guided by the policies of the cabinet or chief executives of those governments.” In recent years, as Anne-Marie Slaughter has noted, policy networks have become much denser as the scale, scope, and types of transgovernmental ties have responded to the challenges of globalization. These networks, she argues, offer “a flexible and relatively fast way to conduct the business of global governance, coordinating and even harmonizing national government action while initiating and monitoring different solutions to global problems” (Slaughter, 2004, p. 11).

A series of horizontal networks have emerged among national government officials in their respective policy arenas, ranging from central banking through antitrust regulation and environmental protection to law enforcement and human rights protection. These networks operate both between high-level officials directly responsive to the national political process, i.e., ministerial level, as well as lower-level national regulators. They discharge several different functions:

- **Information networks** “bring together regulators, judges, or legislators to exchange information and to collect and distill best practices. This information exchange can also take place through technical assistance and training programs provided by one country’s officials to another” (Slaughter, 2004, p. 19).

- **Enforcement networks** “typically spring up due to the inability of government officials in one country to enforce that country’s law, either by means of a regulatory agency or through a court” (Slaughter, 2004, p. 19).
Harmonization networks “bring regulators together to ensure that their rules in a particular substantive area conform to a common regulatory standard” (Slaughter, 2004, p. 20).

In this book we will focus primarily on the harmonization networks that central bankers and bank regulators have established to ensure that the global, integrated financial system operates according to a common set of rules. The BCBS is the most important of these policy networks. Its recommendations and policy papers are now closely followed by many regulators and regulatory agencies around the world, including many that are not represented on the committee itself. The European Union (EU) also plays an important role in setting international bank regulatory standards, sometimes in advance of the BCBS and sometimes following its lead. As Slaughter has argued, the EU can also be thought of as a policy network, although one of a very distinctive type. However, these institutions are only part of a complex series of policy networks that grapple with the mismatch between domain and jurisdiction in the new world of international finance.

How to Use This Book

The first section of this book, comprising four chapters, explores the main justifications for the prudential regulation of banks and explains why a financial safety net is needed. Students who are familiar with such concepts as fractional reserve banking, externalities, and the role of the lender of last resort, perhaps because they have completed an undergraduate course on money and banking, may skip certain sections of these chapters, although they may also find that the relevant policy issues are discussed in greater depth than they may have previously encountered. Students without a background in economics are encouraged to make use of the material in these chapters as well as the appendix, which explains some of the relevant economic theory.

Chapter 1 is concerned with the changing nature of banks. We look at ways in which various legal regimes around the world have attempted to define bank or banking and then turn to consider what it is about banks that has made them subject to a level of regulation that exceeds that applied to most other types of economic activity. Central to the traditional definition of banking is the concept of deposit taking, and the nature of banking involves both the extension of long-term credit while at the same time promising depositors that their funds will be available on demand. We also describe the way in which the nature of banking has been transformed in the past three decades, coming to rely on funding sources other than traditional deposits, such as loans raised from other banks or commercial paper issued in capital markets.
Chapter 2 examines the standard economic case for bank regulation based on the fragility of banks’ promises to repay depositors on demand. A bank can meet its promise to depositors only if all depositors do not ask it to honor its promise at the same time. The inherent fragility of this situation creates an incentive for depositors to engage in runs, and this forms the main traditional justification for the regulation of banks.

Chapter 3 examines another feature of banks. They form an interconnected system of mutual financial obligations. The interconnected system gives rise to the concern that the failure of one bank to meet its obligations will trigger a domino-like collapse of other banks. Although this particular scenario is now thought to be comparatively remote, the shift toward a banking system that is dependent on inter-bank and financial markets for the main source of its funds creates the risk that banks could be brought down by asset price spirals caused by banks attempting to liquidate their assets at the same time. This factor forms a major part of the explanation of the severity of the Global Financial Crisis of 2007–2009.

Chapter 4 considers the financial safety net, the institutions that society has created to protect against the risks described in Chapters 2 and 3. Central to the financial safety net is the role played by the central bank in its capacity of lender of last resort. In addition, deposit insurance also plays an important role in minimizing the incentives for depositors to engage in bank runs. Finally, Treasuries or Ministries of Finance have a role to play as a backstop to the entire system. However, the existence of a safety net encourages moral hazard, giving banks an incentive to take on higher risks in the expectation of being bailed out. Moral hazard serves as the main justification for regulation in that it provides a counterbalance to the distorted incentives created by the financial safety net.

Chapter 5 represents a change of focus and provides a link between the first four chapters and the rest of the book. In it we describe in greater detail the main policy networks and standard setting bodies that have been responsible for developing international standards for bank regulation. We also look at the role played by the European Union in setting bank prudential standards for its member countries.

Chapter 6 is the first chapter in which we turn to the specific regulatory requirements that form the substance of most of the other chapters of this book. In this chapter we examine both the relevant international standards on bank licensing requirements and also how several leading jurisdictions have applied these standards in practice. We also look at issues of corporate governance as applied in particular to banks.

Chapter 7 examines who owns banks. We consider how countries have responded to the questions of whether a commercial (i.e., nonfinancial) firm should be allowed to own or affiliate with a bank and a bank’s affiliation with or ownership by other financial institutions such as insurance companies or securities firms.
Chapters 8, 9, and 10 examine the regulation of bank capital, one of the most important areas of regulation in international banking. The regulation of capital is a highly technical field and is a popular subject in finance literature. This book attempts to describe capital regulation for the nonexpert and, therefore, focuses on overarching policy principles rather than attempting to convey understanding of complex finance principles. Chapter 8 reviews the nature of bank capital and considers why it is necessary for bank regulators to set minimum capital requirements for banks. Chapter 8 introduces the Basel I capital standards that formed the basis for capital regulation around the globe. Chapter 9 considers the ways in which Basel II attempts to deal with limitations in the way that Basel I treated credit risk. Chapter 10 examines Basel II’s treatment of other risks, in particular market and operational risk.

While capital regulation can indirectly limit a bank’s risk taking, in Chapter 11 we consider how regulations do so directly. In this chapter we consider regulations that address credit concentration risk and liquidity risk. This chapter provides a fairly detailed examination of large exposure rules in the United States and the United Kingdom for those that wish to delve deeper into special legal rules.

Chapter 12 examines the practice of consolidated supervision. Consolidated supervision addresses the supervisory challenges that relate to (1) banks operating cross-border and (2) banks operating within larger conglomerate groups that engage in nonbanking activities such as insurance or investment banking.

Chapter 13 looks at international efforts to combat money laundering and terrorist financing, how those efforts impact bank operations, and why these issues are important to bank supervisors (as opposed to criminal prosecutors).

The Global Financial Crisis vividly demonstrates that banks continue to fail despite extensive regulation and monitoring. In Chapter 14 we consider the mechanisms for resolving failed institutions and how such mechanisms are used to resolve financial crises. We also consider the particular challenges posed by cross-border insolvencies.

Chapter 15 visits the international debate over the institutional structure of financial institution regulation. We examine the models adopted around the world and current trends in structural reform.

Chapter 16 concludes the book with a discussion of the Global Financial Crisis. The chapter begins with an examination of the causes of the crisis and considers the extent to which regulation was to blame. Next, the chapter outlines current proposals for reform. While it is too early to know which, if any, of these proposals will be implemented, we believe that reform will engage the policy networks emphasized in this book and may form the next generation of international standards of financial institution regulation.
References


