

GEORGE BAILEY IN THE TWENTY-FIRST CENTURY: ARE WE MOVING TO THE POSTMODERN ERA IN INTERNATIONAL FINANCIAL REGULATION WITH BASEL II?

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INTRODUCTION

Jimmy Stewart in *It's a Wonderful Life*¹ plays small town George Bailey, “honest, decent, generous to a fault.”² *It's a Wonderful Life* is an extremely well-known film about how one life matters to the greater world. But the film also brings home the instability of the financial world and how easily lives can be ruined or saved. The most well-known example of this instability is when George is “driven to the verge of suicide when his dotty uncle loses a wad of cash that he’s supposed to deposit for the family savings and loan.”³ The villain is Mr. Potter (Lionel Barrymore), “the avaricious local banker” out to buy George’s family’s savings and loan.⁴ In an earlier scene we see the goodness of George, when he uses money saved for his honeymoon trip to forestall a run on the savings and loan. The film portrays a simpler time when one’s small personal savings could avert a bank crisis. When George finds himself years later facing another bank crisis, but this time with no similar capital reserve, the townspeople, remembering George’s kindness from years past, “begin to empty their pockets into a large basket, thousands of dollars, in gratitude for what [George] and his company have done in enriching their lives.”⁵ Kindness repaid averts the second banking crisis.

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¹ IT’S A WONDERFUL LIFE (Liberty Films 1946).

² Bob Thomas, *Christmas Classic had an Unpromising Start*, THE ASSOCIATED PRESS, July 3, 1997, <http://www.reelclassics.com/Movies/Wonlife/wonlife-article.htm> (last visited Nov. 9, 2006).

³ *Id.*

⁴ Roger Ebert, *It's a Wonderful Life (1946)*, Jan. 1, 1999, <http://rogerebert.suntimes.com/apps/pbcs.dll/article?AID=/19990101/REVIEWS08/401010376/1023> (last visited Nov. 9, 2006).

⁵ *It's a Wonderful Life*, <http://www149.pair.com/marilynn/IAWL.htm> (last visited Nov. 9, 2006).

Today, the small-town savings and loan pitted against the evil small-town banker has been replaced by sophisticated global market economies of a scale unfathomable to George Bailey and Mr. Potter. However, the same concerns and risks—albeit on a much larger scale—exist today: how does a financial institution survive when mistakes, runs on banks, or fraud occurs? The modern, and now postmodern, solution came in the form of the Basel agreements. The 1988 Basel Accord (“Basel I”) established 8%⁶ of regulatory capital as the minimum international standard in order to prevent panics on a global scale like those seen in *It’s a Wonderful Life*.⁷ Basel II, the latest version being debated and possibly implemented in the coming years, carries those concerns and potential solutions into the twenty-first century.

The Basel Accords have had, and will continue to have, a tremendous influence on the world’s financial and banking interests, as they rewrite the rules of banking.⁸ These agreements are promulgated, not by governments, but by a small committee of elite bankers from high-powered central banks.⁹ In fact, no national legislatures voted to approve Basel I.¹⁰ In spite of this, banks all over the world, both large and small, in developing and developed countries, have adopted the Basel Accords. It is hardly an overstatement to say that the financial world is under the power of Basel. As Professor John Eatwell writes, “An important part of Britain’s economic future is being determined by a committee sitting in Basel, Switzerland.”¹¹ This statement could easily be expanded to encompass the world. To date, over a

⁶ Riskglossary.com, Basel Committee on Banking Supervision, http://www.riskglossary.com/articles/basle_committee.htm (last visited Nov. 9, 2006) [hereinafter Basel Committee on Banking Supervision].

⁷ In many ways, *It’s a Wonderful Life* harkens back to the bank closures of the 1920s, where annually in the U.S. there were about 500 bank closures due to bank failure. Many of the failed banks were similar to Bailey’s bank, a small, rural one-unit bank. See MILTON FRIEDMAN & ANNA JACOBSON SCHWARTZ, A MONETARY HISTORY OF THE UNITED STATES 1857–1960, at 249 (1963) [hereinafter FRIEDMAN & SCHWARTZ].

⁸ See John Eatwell, *Basel II: The Regulators Strike Back*, THE OBSERVER, June 9, 2002, available at <http://observer.guardian.co.uk/business/story/0,,729690,00.html> [hereinafter Eatwell, *Basel II*].

⁹ *Id.*

¹⁰ *See id.*

¹¹ *Id.*

hundred countries have adopted the Basel Accord, now referred to as Basel I,¹² and a similar situation is expected with Basel II.

This Article explores the development of these banking regulations as a measure of our increasingly globalized world. The Basel Committee is a window into our history and our future. Basel I sought a solution to the kinds of problems George Bailey was facing, although on an international scale, as the local gave way to the international. Even so, in a relatively short time, Basel I was outgrown. As a response, Basel II will institutionalize and legalize a two-tiered banking system, at least in the United States. Such a solution moves us even further from the cultural conditions and crises depicted in *It's a Wonderful Life*.¹³ A handful of large international banks will follow the new Basel II, while smaller U.S. banks will continue to follow Basel I.¹⁴ In addition, Basel II will extend beyond banks to reach other financial institutions, including the International Monetary Fund ("IMF").¹⁵

Experts and scholars are asking whether Basel II will lead to greater harmony and universality within the international banking world.¹⁶ Will Basel II bring greater stability or, as some predict, new uncertainty? This Article adds to the dialogue by viewing the question through a slightly different lens: that of a world changing from a modernist to postmodernist social paradigm. Just as George Bailey represents the simple, pre-modern banking world, Basel I can be read as a modern text on

¹² L. Jacabo Rodríguez, *International Banking Regulation: Where's the Market Discipline in Basel II?*, POLY ANALYSIS, Oct. 15, 2002, at 1, available at <http://www.cato.org/pubs/pas/pa455.pdf> [hereinafter Rodríguez].

¹³ See Testimony of Roger W. Ferguson, Jr. before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate, June 18, 2003, <http://www.federalreserve.gov/boarddocs/testimony/2003/20030618/default.htm> (last visited Nov. 9, 2006).

¹⁴ See *id.*

¹⁵ Eatwell, *Basel II*, *supra* note 8.

¹⁶ See, e.g., Daniel K. Tarullo, Testimony before the U.S. Senate Committee on Banking, Housing, and Urban Affairs, Sept. 26, 2006, available at 2006 WLNR 16671335; *Analysis: A very traditional approach to financial innovation*, FT.COM, Sept. 26, 2006, http://www.ft.com/cms/s/1d36d3a0-4d72-11db-8704-0000779e2340,dwp_uuid=824a0bea-4d72-11db-8704-0000779e2340.html (last visited Nov. 9, 2006); Testimony of Susan Schmidt Bies before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate, September 26, 2006, <http://www.federalreserve.gov/boarddocs/testimony/2006/20060926/default.htm> (last visited Nov. 9, 2006).

international financial institutional markets, and Basel II as a postmodern text on a more complex, globally-linked economic world. In adding this theoretical scope of modernism/postmodernism, we read the evolution of the Basel Agreements as reflective of a larger cultural shift, rather than merely as a response to the immediate changing conditions.

Part I presents a brief history, beginning with the creation, development, and collapse of Bretton Woods; the resulting 1973 banking crises; and the creation of the Basel Committee in 1974. Part II looks at Basel I. Part III turns to Basel II, including the current concerns and criticisms regarding its implementation. Part IV concludes with a reading of the Basel agreements through modern and postmodern theory, as a way to understand the shifts of our increasingly complex and globalized village.

I. THE BIRTH OF THE MODERN ERA OF INTERNATIONAL FINANCIAL REGULATION

The soon-to-be-implemented Basel II is a response to concerns that Basel I is too outdated for our currently complex, international financial world.¹⁷ Basel II grows out of the work of the Basel Committee, which seeks to standardize banking regulation around the world and across jurisdictions.¹⁸ It is preceded by the 1975 Basel Concordat, the Revised Basel Concordat, Basel I, and the 1996 Amendment to Basel I.¹⁹ All of these developments are fairly recent; this Section places them in historical context.

¹⁷ Basel Committee on Banking Supervision, *supra* note 6.

¹⁸ *Id.*

¹⁹ See Patricia Jackson, *International Financial Regulation and Stability*, Fin. & Reg. Seminar Series at the Judge Inst. of Mgmt., Mar. 8, 2002, at app. 1-3, available at <http://www.cerf.cam.ac.uk/publications/index.php?current=5>.

A. The Creation and Collapse of Bretton Woods

*Seldom can there have been concentrated for the ordering of human affairs so comprehensive a combination of economic and political vision, of administrative and technical expertise, of idealism and interest.*²⁰

- Lord Eric Roll, historian and
chairman of a London merchant bank

The collapse of the Bretton Woods system in the early 1970s²¹ encouraged the development of the Basel Committee. It is important to understand this economic transition in order to better understand the economic significance of Basel I and Basel II within the socioeconomic cultural context.

World War II brought new extremes of rationalization to a series of industries that had been developing in the preceding decades, including “[c]ars, shipbuilding, and transport equipment, steel, petrochemicals, rubber, consumer electrical goods, and construction.”²² These industries of production, utilizing “interlinked financial centres—with the United States and [specifically] New York at the apex of its hierarchy— . . . drew in massive supplies of raw materials from” around the world.²³ They produced goods that were in turn distributed to “an increasingly homogenous mass world market.”²⁴ This system depended on “state-sponsored reconstruction of war-torn economies, suburbanization particularly in the United States, urban renewal, geographical expansion of transport and communications systems, and infrastructural development both within and outside the advanced capitalist world.”²⁵ It also required a tacit structural agreement between the state, increasingly large and profitable corporations, and organized labor.²⁶ The

²⁰ MICHAEL MOFFITT, *THE WORLD’S MONEY: INTERNATIONAL BANKING FROM BRETTON WOODS TO THE BRINK OF INSOLVENCY* 14 (1983) [hereinafter MOFFITT].

²¹ *See generally id.* at 13-40 (describing the rise and fall of the Bretton Woods system).

²² DAVID HARVEY, *THE CONDITION OF POSTMODERNITY* 132 (1989) [hereinafter HARVEY].

²³ *Id.*

²⁴ *Id.*

²⁵ *Id.*

²⁶ *See id.* at 132-34.

primary historical factors giving rise to this tacit agreement include expansive U.S. industrial production coupled with the need to rebuild European and foreign economies to absorb that production.²⁷ For the U.S. to meet those demands, both domestically and internationally, however, a new financial world system had to be conceived.²⁸ This new financial world came in the form of the Bretton Woods system.²⁹

In 1944, in the midst of World War II, more than 700 delegates from the forty-four Allied countries met in Bretton Woods, New Hampshire to discuss the creation of a set of international financial institutions.³⁰ The delegates were beginning to imagine and create what a post-war world would look like, even though the war itself would last another full year.³¹ The Bretton Woods system created the World Bank to provide reconstruction money for Europe, and the IMF to provide short-term loans for national governments.³² The system also created rules governing commercial and financial interactions with countries around the world.³³ The Committee hoped that these measures would help stabilize currencies and avoid restrictive exchange practices.³⁴

Planning for postwar reconstruction had begun as early as 1942.³⁵ The main architects of those plans, John Maynard Keynes from Great Britain and Harry Dexter White from the United States, oversaw the transformation of these plans into an international agreement at the Bretton Woods conference.³⁶ The principal goal of

²⁷ *Id.* at 136-37.

²⁸ *Id.* at 137.

²⁹ *Id.*

³⁰ MOFFITT, *supra* note 20, at 13.

³¹ *Id.*

³² TED NACE, *GANGS OF AMERICA: THE RISE OF CORPORATE POWER AND THE DISABLING OF DEMOCRACY* 189 (2003).

³³ SAMUEL ROSENBERG, *AMERICAN ECONOMIC DEVELOPMENT SINCE 1945: GROWTH, DECLINE AND REJUVENATION* 84 (2003) [hereinafter ROSENBERG].

³⁴ *See id.*

³⁵ MOFFITT, *supra* note 20, at 20.

³⁶ *Id.* at 13.

Bretton Woods was to stabilize the world's economy for prosperous world trade.³⁷ The U.S. sought a postwar economic arrangement that would give it access to European and foreign markets as they were rebuilt, and that would allow U.S. corporations to invest in those markets through the removal of restrictions on international capital flows.³⁸ While access to foreign markets significantly benefited the U.S., it was viewed as simultaneously benefiting all nations involved because it was believed that the U.S. "could act as an engine for global recovery."³⁹ In short, the U.S. needed access to these rebuilt markets for its industrial surplus and for overall growth; reciprocally, these markets needed U.S. resources in order to rebuild and develop. Negotiated in just over three weeks of "marathon discussions," the Bretton Woods Accord established an international framework for what has been recognized as "the greatest economic boom in history."⁴⁰

A key feature of Bretton Woods was the means by which it sought both "stability and flexibility."⁴¹ Prior to Bretton Woods, through the nineteenth and early part of the twentieth centuries, nations by and large "tied their currencies to gold."⁴² This correlation between currency and gold resulted in "the volume of currency in circulation [being] limited by the nation's gold supply."⁴³ Keynes and White, viewing a traditional gold standard as overly restrictive on international economic growth and development, sought an alternative; nevertheless, they were forced by practicality "to mollify the powerful New York bankers who were staunchly pro-gold."⁴⁴ The result was a middle ground in which the U.S. dollar was tied to gold, with the U.S. Treasury pledging "to redeem foreign dollar holdings in gold at the 1934 price of \$35 per ounce,"⁴⁵ while the values of other world currencies were tied to the U.S. dollar.⁴⁶

³⁷ *Id.* at 20.

³⁸ *See id.* ("The aim was to establish new trading rules the major trading companies could live with and entrust a new international agency with the authority to enforce them.").

³⁹ *Id.* at 16.

⁴⁰ *Id.* at 14.

⁴¹ *Id.* at 20.

⁴² *Id.*

⁴³ *Id.*

⁴⁴ *Id.* at 21.

⁴⁵ *Id.*

History had taught that a single stabilizer was needed,⁴⁷ and because of U.S. hegemonic dominance in the world, that role fell to the U.S. Further stability in the international system was achieved by establishing “fixed exchange rates between [world] currencies,” with changes in those rates requiring approval by the IMF.⁴⁸

As planned at Bretton Woods, the U.S. dollar, following the end of World War II, flooded into western nations, helping many of those nations rebuild and develop vibrant industrial economies.⁴⁹ For more than a decade, the strength of the U.S. dollar fostered an unparalleled economic boom, with the U.S. benefiting above all others.⁵⁰ What was unforeseen, however, was how quickly a U.S. dollar overhang—the excess of U.S. dollars in circulation beyond what U.S. gold reserves could satisfy—would emerge in the international arena. What was unimaginable at the close of World War II appeared as a stark reality by 1958: the number of U.S. dollars circulating worldwide and guaranteed by the U.S. as exchangeable for gold at \$35 an ounce threatened, in short order, to exceed the U.S. gold supply should foreign nations suddenly choose to cash them in.⁵¹ By 1960, a number of foreign governments began to fear a devaluation of the U.S. dollar and began converting a portion of their U.S. currency holdings; the feared projection became a reality.⁵²

The U.S. was able to sustain the Bretton Woods system for more than a decade beyond this point.⁵³ However, throughout the 1960s and into the 1970s the system experienced increasing strain from many different sources, most importantly the U.S. balance of payments crisis that emerged in the late 1950s and continued to worsen.⁵⁴ The shortage of U.S. dollars that made them so valuable following World

⁴⁶ ROSENBERG, *supra* note 33, at 86.

⁴⁷ MOFFITT, *supra* note 20, at 19.

⁴⁸ *Id.* at 21.

⁴⁹ See ROSENBERG, *supra* note 33, at 97, 93 (“European economies . . . experienced[d] a great economic boom in the 1950s and 1960s.”).

⁵⁰ MOFFITT, *supra* note 20, at 14.

⁵¹ ROSENBERG, *supra* note 33, at 97.

⁵² *Id.* at 97-98.

⁵³ See *id.* at 179 (“[B]y August 1971, the Nixon Administration had concluded that the Bretton Woods system had outlived its usefulness for the United States.”).

⁵⁴ See *id.* at 103-04.

War II had become a glut by the early 1970s.⁵⁵ This growing glut threatened a forced devaluation and, ultimately—because the U.S. dollar underpinned the system of exchange and value—an unraveling of the entire Bretton Woods structure. Ironically, when this did finally occur in the early 1970s, U.S. banks and corporations were at the fore in bringing about its demise.⁵⁶

U.S. banks experienced a slow international expansion through the 1950s and into the 1960s as they followed U.S. corporations abroad in pursuit of foreign direct investment and market opportunities.⁵⁷ Following 1965, however, international banking began to come into its own.⁵⁸ This coincided with the rise of the Eurodollar market.⁵⁹ Operating “as a kind of dollar market in exile,”⁶⁰ the Eurodollar market provided a structure and means for U.S. banks and corporations to transact beyond U.S. regulatory oversight.⁶¹ With this structure in place, and as the U.S. dollar became increasingly vulnerable at the end of the 1960s and early 1970s, the Eurodollar market functioned as the platform from which banks (U.S. and otherwise) could attack and further devalue the U.S. dollar.⁶² As one commentator notes, this was nothing short of “a struggle between governments and the private banks for control over the international monetary system.”⁶³

In the early 1970s, with the U.S. dollar already demonstrably weak, “corporations and banks, anticipating a devaluation, sold dollars on Europe’s money markets in order to reduce their cash exposure in dollars.”⁶⁴ The U.S., after

⁵⁵ See MOFFITT, *supra* note 20, at 34.

⁵⁶ See *id.* at 77.

⁵⁷ *Id.* at 42-44.

⁵⁸ *Id.* at 50.

⁵⁹ See *id.* at 46-48.

⁶⁰ *Id.* at 46.

⁶¹ See *id.* at 66 (“Being transnational, the Euromarket is virtually free of all government regulation.”).

⁶² See *id.* at 74-75, 77.

⁶³ *Id.* at 71.

⁶⁴ *Id.* at 77.

repeatedly failing in its efforts to prop up the value of the dollar, finally succumbed to economic pressures.⁶⁵ In March 1973, in an effort to halt the U.S. dollar's decline in value, the foreign currency markets were closed (for the second time); when they reopened two and a half weeks later, currency values were allowed to float.⁶⁶ Although initially intended to be a temporary condition, the continued speculation against the U.S. dollar, which further devalued it, made the economic reality quickly apparent: the Bretton Woods system was no more.⁶⁷

The 1970s saw the dissolution of many of the fundamental economic structural tenets that were put in place as part of the Bretton Woods agreement established at the end of World War II. With its collapse, longstanding financial controls were abolished, including exchange controls, quantitative controls on credit, and domestic restrictions.⁶⁸ By the end of the Bretton Woods era, new modern banking had come into existence;⁶⁹ within a few years, the need for modern banking regulations would be manifestly apparent.⁷⁰ Just as Bretton Woods helped expand and stabilize a post-war world, new agreements were needed to keep the banking and financial worlds stable. Because so many banks were now linked internationally, bank failure in one part of the world could trigger economic disaster in another part of the world. This possibility was brought home in 1974.

B. The Herstatt Debacle

A number of reasons are given for the need to regulate financial and banking markets, namely the protection of customers from lack of transparency, monopoly power of a few banks operating within a particular market, and criminal activities by banks and others.⁷¹ As the world becomes more global, the need for international

⁶⁵ See *id.* at 73-75.

⁶⁶ *Id.* at 75.

⁶⁷ *Id.*

⁶⁸ Eatwell, *Basel II*, *supra* note 8.

⁶⁹ See MOFFITT, *supra* note 20, at 44-55.

⁷⁰ SHELAGH HEFFERNAN, MODERN BANKING 361 (2005) [hereinafter HEFFERNAN].

⁷¹ *Id.* at 173-74.

regulation increases.⁷² This need could not have been demonstrated better than it was in the summer of 1974.

Two bank failures in 1974 spurred the creation of the Basel Committee. One of these failures has come to be known as the Herstatt Debacle, a banking crisis that was initiated in Germany, but proceeded to spread around the world. On June 26, 1974, Bank Herstatt, a German bank, was forced into liquidation by German regulators.⁷³ The bank had run up huge “losses from foreign exchange trading, which were originally estimated at £83 million but rose to £200 million.”⁷⁴ In that instance “a number of banks had released payment of DEM to Herstatt in Frankfurt in exchange for USD . . . to be delivered in New York. Because of the time-zone differences, Herstatt ceased operations between . . . respective payments. The counterparty banks did not receive their USD payments.”⁷⁵ As Heffernan explains,

The bank’s failure is famous because it exposed a weakness in the system related to liquidity risk. Bankhaus Herstatt was due to settle the purchase of Deutsche marks (DMs, in exchange for dollars) on 26 June. On that day, the German correspondent banks, on instruction from the American banks, debited their German accounts and deposited the DMs in the Landes Central bank (which was acting as a clearing house). The American banks expected to be repaid in dollars, but Bankhaus Herstatt was closed at 4 p.m., German time. It was only 10 a.m. on the US east coast, causing these banks to lose out because they were caught in the middle of a transaction. The US payments system was put under severe strain. The risk associated with the failure to meet interbank payment obligations has since become known as Herstatt risk. In February 1984, the chairman of the bank was convicted of fraudulently concealing foreign exchange losses of DM 100 million in the bank’s 1973 accounts.⁷⁶

⁷² Eatwell, *Basel II*, *supra* note 8.

⁷³ Basel Committee on Banking Supervision, *supra* note 6.

⁷⁴ HEFFERNAN, *supra* note 70, at 361.

⁷⁵ Basel Committee on Banking Supervision, *supra* note 6.

⁷⁶ HEFFERNAN, *supra* note 70, at 361.

The Hertstatt bank was considered a failed bank.⁷⁷ But Herstatt was not the only bank failure that year. A month before, Franklin National Bank (“FNB”) in the U.S. also faced serious problems. This bank was the twentieth largest in the U.S., with deposits of close to \$3 billion.⁷⁸ It too “suffered very large foreign exchange losses and could not pay its quarterly dividend. It transpired that in addition to these losses, the bank had made a large volume of unsound loans, as part of a rapid growth strategy.”⁷⁹ These revelations led large depositors to withdraw their money; it was later discovered that its largest shareholder, Michele Sindona, had used the bank to “channel funds illegally around the world.”⁸⁰

The Herstatt Debacle and FNB’s problems ultimately led to the creation of the Basel Committee.⁸¹ But this was far from the first instance of a bank failure or mismanagement. As many have noted, international and global banking began with the first instances of trade hundreds of years ago,⁸² and banks have been subject to regulations concerned with safety and soundness of the banking system since at least the 1930s, following the stock market crash.⁸³ Why, then, was there considered a need for a new banking accord in the 1980s, and again for the twenty-first century? Why do banks need to be regulated on a global scale?

⁷⁷ A bank is deemed to have “failed” if it is liquidated; merged with a healthy bank under central government supervision or pressure; or rescued with state financial support. *See* HEFFERNAN, *supra* note 70, at 352.

⁷⁸ *Id.* at 361.

⁷⁹ *Id.*

⁸⁰ *Id.* at 362. Heffernan writes, “In March 1985 [Michele Sindona] died from poisoning, a few days after being sentenced to life imprisonment in Italy for arranging the murder of an investigator of his banking empire.” *Id.*

⁸¹ *See* Basel Committee, *History of the Basel Committee and Its Membership*, March 2001, at 1, available at www.bis.org/publ/bcbsc101.pdf.

⁸² Jaime Caruana, Chairman, Basel Comm. on Banking Supervision, What Next for Basel? (Oct. 9, 2003), available at <http://www.bde.es/prensa/intervenpub/archivo/caruana/091003e.pdf#search=%22Remarks%20of%20Governor%20Jaime%20Caruana%2C%20Chairman%20of%20the%20Basel%20Committee%20on%20Banking%20Supervision%20What%20Next%20for%20Basel%3F%22>.

⁸³ *See* Kenneth E. Scott, *The Patchwork Quilt: State and Federal Roles in Bank Regulation*, 32 STAN. L. REV. 687, 696 (1980).

Part of the answer lies in the fact that in the 1970s and 1980s, as Harper and Chan note, “banking systems around the world were substantially deregulated, reflecting a prevailing view that regulation had become a distorting influence on the industry, no longer serving its original public policy goals.”⁸⁴ What changed is how regulatory systems are seen. Previously, “[r]egulation of banks has usually come in the form of entry restrictions, limits on activities, geographical restrictions, reserve requirements, and capital requirements.”⁸⁵ Governments feared finance wars, and therefore began regulating interest rates and other activities.⁸⁶ Now, regulation tends to be seen as a means to “safety and soundness” in banking on a larger, global scale.⁸⁷ Both Basel I and Basel II address this view: international regulation requirements keep banks stable and the markets less vulnerable to bank failures.⁸⁸ The focus on how to prevent more Herstatt crises, the Basel Committee believes, is a focus on risk-weighted capital adequacy regulations.⁸⁹

What happened with Herstatt is known as contagion, when the spread of one bank’s problems infect other banks and the banking system as a whole.⁹⁰ This creates systemic risk, which can cause problems across the entire global

financial system, leading to widespread bank runs by wholesale and retail depositors, and possibly, collapse of the banking system. An extensive collapse will result in the loss of intermediation, money transmission and liquidity services offered by banks which, in turn,

⁸⁴ Ian R. Harper & Tom C.H. Chan, *The Future of Banking: A Global Perspective*, in *THE FUTURE OF BANKING* 30, 37 (Benton E. Gup ed., 2003) [hereinafter Harper & Chan].

⁸⁵ See GEORGE J. BENSTON, REGULATING FINANCIAL MARKETS: A CRITIQUE AND SOME PROPOSALS 80-84 (1998); Randall S. Kroszner, *Financial Regulation*, in *THE ELGAR COMPANION TO AUSTRIAN ECONOMICS* 419, 421 (Peter J. Boettke ed., 1994) [hereinafter Kroszner]; Edward J. Kane, *Ethical Foundations of Financial Regulations*, 12 *J. OF FIN. SERVICES RES.* 51, 51-52 (1997); CHARLES GOODHART ET AL., FINANCIAL REGULATION: WHY, HOW AND WHERE NOW? 189-202 (1998).

⁸⁶ See Kroszner, *supra* note 85, at 420; Harper & Chan, *supra* note 84, at 37.

⁸⁷ Harper & Chan, *supra* note 84, at 37.

⁸⁸ Basel Committee on Banking Supervision, *supra* note 6.

⁸⁹ *Id.*

⁹⁰ HEFFERNAN, *supra* note 70, at 175. See generally Charles W. Calomiris & Joseph R. Mason, *Contagion and Bank Failures During the Great Depression: The June 1932 Chicago Bank Panic*, 87 *AM. ECON. REV.* 863 (1997) (discussing the “social costs of asymmetric-information induced bank panics in an environment without government deposit insurance”).

will cause an inefficient allocation of resources in the economy. In the extreme, the economy could revert to barter exchange.⁹¹

But in regulating and protecting banks, society also runs into a moral hazard problem: when the government determines that one sector of society is too important to fail (and thus is given insurance), it gives that sector latitude to misbehave or participate in riskier ventures.⁹²

To prevent such catastrophic losses, both in the local and global arena, national banking systems created special regulations for banks—so-called “prudential regulation”—which sought to minimize the social costs of bank failures.⁹³ Most of these regulations were on the micro level, including Basel I and Basel II.⁹⁴ They set requirements of what banks must do to keep from being in the precarious position of failing.⁹⁵ But some scholars, including Claudio Borio, believe we should be looking at the macro level as well.⁹⁶ Borio argues that banks should be seen as a collective whole, all engaged in similar activities; therefore, problems can arise that affect them simultaneously.⁹⁷

Prudential regulation, however, has become key in the global banking environment, mainly in order to prevent another Herstatt.⁹⁸ Prudential regulation

⁹¹ HEFFERNAN, *supra* note 70, at 175.

⁹² *Id.* at 176.

⁹³ *Id.*

⁹⁴ *See id.* (“As this chapter proceeds, it will become apparent that prudential regulation focuses on bank regulation at the micro level, i.e. ensuring that each bank behaves in a prudent manner, to prevent systemic failure arising from contagion if one bank fails.”).

⁹⁵ *See id.*

⁹⁶ HEFFERNAN, *supra* note 70, at 176; Claudio Borio, *Towards a Macroprudential Framework for Financial Supervision and Regulation?*, 49 CESIFO ECON. STUD. 181, 182 (2003), available at <http://cesifo.oxfordjournals.org/cgi/reprint/49/2/181>.

⁹⁷ HEFFERNAN, *supra* note 70, at 176.

⁹⁸ Boris Kozolchik explains,

The notion of prudential regulation is central to an understand[ing] of what is being attempted, especially by Basle II [sic]. Central bankers differ in their understanding

takes the form of deposit insurance, capital requirements, licensing and examination of banks, and intervention when banks get into trouble.⁹⁹ It is designed to ensure the stability of banking, without banks taking advantage of their position.¹⁰⁰ Compliance costs go down if all international banks are required to meet the same standards.¹⁰¹ The knowledge that specific standards are in place builds confidence in both domestic and foreign banks, and provides stability from bank failure.¹⁰² And, prudential regulation levels the playing field, allowing smaller banks to compete in a global market. This Article looks specifically at the capital requirements established in Basel I, the 1998 revisions, and Basel II.

C. Basel(s) and the Need for Global/International Regulation of Risk-Weighted Capital Adequacy in Banks, or the Birth of the Modern Era

The Committee on Banking Regulations and Supervisory Practices (the “Basel Committee”) is credited with starting the modern era in banking regulation.¹⁰³ When the 1974 crises occurred, “[t]he failure of that German firm had seriously threatened the American banking system, an eventuality that neither German nor US

of this type of regulation. To some, practically anything goes under the heading of “prudential”, they tend to read language such as the one in your paper (referring to a combination of deposit insurance, margins, reserves, inspections[,] etc) as amounting to prudential regulation. Others, more correctly, I believe, see prudential regulation as a providing some upper and lower of limits for various measurements of liquidity, safety and soundness rules and then allowing banks to operate within those limits.

Email from Boris Kozolchyk to W. Ronald Gard (Dec. 7, 2005) (on file with author).

⁹⁹ *See id.*

¹⁰⁰ HEFFERNAN, *supra* note 70, at 176.

¹⁰¹ *Id.*

¹⁰² Patricia Jackson, William Perraudin & Victoria Saporta, *Regulatory and ‘Economic’ Solvency Standards for Internationally Active Banks* 9, at 11 (Bank of England, Working Paper No. 1368-5562, 2001), available at www.bis.org/bcbs/events/b2eajps.pdf.

¹⁰³ The Federal Reserve, *Capital Standards for Banks: The Evolving Basel Accord*, available at <http://www.federalreserve.gov/pubs/bulletin/2003/0903lead.pdf> [hereinafter FRB Capital Standards for Banks].

regulators were, at that time, properly equipped to tackle.”¹⁰⁴ The Basel Committee was formed as a response “to the cross-jurisdictional implications of the Herstatt debacle” as well as the problems with FNB the same year.¹⁰⁵ The Committee was supposed to coordinate and establish regulatory conditions among banks to prevent a similar debacle.¹⁰⁶ The Committee is comprised of individuals from central banks and regulatory authorities from the G-10 countries, which include Belgium, Canada, France, Germany, Luxembourg, Italy, Japan, the Netherlands, Sweden, the United Kingdom, and the United States.¹⁰⁷ While not having legislative or any other formal authority, the Basel Committee does require its member countries to implement its recommendations, although with flexibility, of course.¹⁰⁸ The Committee meets every three months in Basel at the Bank for International Settlements.¹⁰⁹

The Committee was formed to look at regulatory practices and issues of international banks in member countries, and “to use concordats and agreements to prevent any international banking operation from escaping effective supervision.”¹¹⁰ In short, it seeks to prevent another Herstatt. The Committee pursues three primary objectives: “[1] define roles of regulators in cross-jurisdictional situations; [2] ensure that international banks or bank holding companies do not escape comprehensive supervision by a ‘home’ regulatory authority; [and 3] promote uniform capital requirements so banks from different countries may compete with one another on a ‘level playing field.’”¹¹¹ Throughout its history, Basel has expanded its scope and

¹⁰⁴ John Eatwell, *The New International Financial Architecture: Promise or Threat?*, available at <http://www.cerf.cam.ac.uk/publications/files/Cambridge-MIT%20lecture%2022.5.pdf>.

¹⁰⁵ Basel Committee on Banking Supervision, *supra* note 6.

¹⁰⁶ *Id.*

¹⁰⁷ *Id.*

¹⁰⁸ *Id.*

¹⁰⁹ The Bank for International Settlements (“BIS”) provides revenue for the permanent secretariat, and is owned by the central banks. It plays no role in policy-making. Formed in 1930, the BIS is one of the oldest international financial institutions. It is actively involved in securing and maintaining international central banks cooperation. *See* Bank for International Settlements, BIS History – Overview, <http://www.bis.org/about/history.htm> (last visited Nov. 9, 2006).

¹¹⁰ HEFFERNAN, *supra* note 70, at 180.

¹¹¹ Basel Committee on Banking Supervision, *supra* note 6.

depth of sophistication. The first Basel Agreement came in 1975, where home and host countries were given specific supervisory responsibility in particular areas, such as liquidity and solvency.¹¹²

D. Further Crises in 1982

Each new edition seeks to fill gaps. The Revised Basel Concordat in 1983, for example, did just that, after another series of bank failures, including the failures of Banco Ambrosiano and its subsidiary in 1982.¹¹³ “As a result . . . the Concordat was revised so that home and host supervisors now have *joint* responsibility for solvency problems of subsidiaries and liquidity problems from either a subsidiary or branch.”¹¹⁴ In addition, a second event put pressure on the Basel Committee to maintain stability in the international financial markets; in August 1982, Mexico announced that it was

unable to roll over its debt to private creditors and would therefore be forced to suspend principal payments. Soon after, other developing countries such as Argentina, Brazil, and Venezuela, among others, found themselves in financial difficulties. U.S. banks, which had lent recklessly to Latin American countries in the 1970s and early 1980s, faced huge losses. Indeed, the nine largest U.S. banks had loans outstanding to the most indebted countries that were equivalent to almost twice their capital at the end of 1982. Those banks had also lent 140 percent of their capital to Mexico, Brazil, and Argentina. Although U.S. banks curtailed substantially their lending to developing nations after Mexico’s announcement, they still faced the possibility of becoming insolvent if the debtor countries

¹¹² See generally Banks for International Settlements, Principles for the Supervision of Banks’ Foreign Establishments (May 1983), <http://www.bis.org/publ/bcbsc312.pdf> (describing “the responsibilities of banking supervisory authorities for monitoring the prudential conduct and soundness of the business of banks’ foreign establishments”).

¹¹³ HEFFERNAN, *supra* note 70, at 180-81. The bank failed “after its Chairman, Roberto Calvo, was found hanging from Blackfriars Bridge in London. Depositors panicked upon hearing the news; a lifeboat rescue was launched by the Bank of Italy (\$325 million), but the bank was declared bankrupt in late August 1982.” *Id.*

¹¹⁴ *Id.* at 181.

defaulted. It was at this stage that the U.S. government orchestrated a resolution to the crisis.¹¹⁵

The U.S. gave loans to Mexico, and instructed the IMF to give rescue packages to the other countries.¹¹⁶ The U.S. Congress made efforts to provide additional loans to developing countries caught in the crisis, but only in exchange for new regulations in the banking industry, “including higher capital requirements.”¹¹⁷

The idea of new regulations concerned the U.S. banking community; in particular, U.S. banks feared they would be less competitive with Japanese and German banks, so there was a great push to make the new regulations international.¹¹⁸ The first step towards international regulations came in 1986 when the U.S. and the U.K. signed a bilateral treaty agreeing to minimum capital standards.¹¹⁹ With these two powerhouses behind international regulations, the G-10 (Basel) Committee was presented with a proposal. The U.S. also threatened to apply the new minimum capital regulation standards to international banks operating within the U.S.¹²⁰ In 1987, the Basel Committee began discussions, with the U.S. and the U.K. on one side of the table, and Japan on the other.¹²¹

II. THE 1988 BASEL ACCORD

The Basel Accord was released in 1988; it “proposed a set of minimum capital requirements for banks.”¹²² These requirements became law in 1992 in the G-10 countries, with Japanese banks requiring an extended period to comply.¹²³ The

¹¹⁵ Rodríguez, *supra* note 12, at 6.

¹¹⁶ *Id.*

¹¹⁷ *Id.*

¹¹⁸ *Id.* at 6-7.

¹¹⁹ *Id.* at 7.

¹²⁰ *Id.*

¹²¹ *Id.*

¹²² Basel Committee on Banking Supervision, *supra* note 6.

¹²³ *Id.*

goal of the Basel Accord was to gain greater stability for international banks.¹²⁴ This was done by focusing on the supervision of banking operations. “The 1988 Basel Accord established a single set of capital adequacy standards for international banks of participating countries from January 1993.”¹²⁵ Now known as Basel I, it required “all international banks to set aside capital based on the (Basel) risk assets ratio”: capital/weighted risk assets.¹²⁶

The Basel Accord applies only to banks; it does not apply to securities firms (investment banks or broker-dealers).¹²⁷ The U.S., the U.K., and Japan distinguish between the two, while the other G-10 countries have “a tradition of universal banking.”¹²⁸ “Banking” in this sense is the act of “deposit taking and lending,” which are the activities that constitute commercial banking under U.S. law.¹²⁹ The primary issue addressed by the Basel Accord is credit risk.¹³⁰

A. Framework for Measuring Risk

The 1988 Basel Accord created a four-part “framework for measuring capital adequacy in relation to credit risk”: 1) defining what is capital; 2) determining risk-weighting rates for types of assets; 3) determining the ratio of capital required for each risk-weighted asset; and 4) determining the conversion of off-balance sheet assets to risk-weighted assets.¹³¹

¹²⁴ See Carl Felsenfeld & Genci Bilali, *A Speculation on the Future of the Bank for International Settlements*, 18 *TRANSNAT'L LAW*. 231, 236 (2005).

¹²⁵ HEFFERNAN, *supra* note 70, at 182.

¹²⁶ *Id.*

¹²⁷ Basel Committee on Banking Supervision, *supra* note 6.

¹²⁸ *Id.*

¹²⁹ *Id.*

¹³⁰ *Id.*

¹³¹ Rodríguez, *supra* note 12, at 7.

1. Determining Capital: Tiers 1 and 2

Basel I divided a bank's capital into two tiers.¹³² Tier 1 was comprised of "core capital," which included "common equity shares, disclosed reserves, non-cumulative preferred stock, other hybrid equity instruments, retained earnings, minority interests in consolidated subsidiaries, less goodwill and other deductions."¹³³ Tier 2 was comprised of "supplementary capital," which included "(1) *upper tier 2*-capital such as cumulative perpetual preferred stock, loan loss allowances, undisclosed reserves, revaluation reserves (discounted by 55%) such as equity or property where the value changes, general loan loss reserves, hybrid debt instruments . . . and (2) *lower tier 2*-subordinated debt"¹³⁴

Basel I also defined the amount of each type of capital a bank could hold.¹³⁵ Tier 2 capital was limited to a maximum equivalent of Tier 1 capital.¹³⁶ "Subordinated debt [was] limited to a maximum of 50 percent of Tier 1 capital. General loan-loss reserves are limited to a maximum of 25 percent of Tier 2 capital."¹³⁷

2. Five Risk Rates

Currently, there are five risks rates under Basel I: 0%, 10%, 20%, 50%, and 100%, which are applied to various risk categories.¹³⁸ These rates apply to both tiers of capital.¹³⁹ One of the greatest complaints against the system is that qualitative

¹³² See HEFFERNAN, *supra* note 70, at 182.

¹³³ *Id.*

¹³⁴ *Id.*

¹³⁵ Rodríguez, *supra* note 12, at 7-8.

¹³⁶ *Id.*

¹³⁷ *Id.* at 8.

¹³⁸ FRB Capital Standards for Banks, *supra* note 103, at 396 n.2.

¹³⁹ Gary A. Goodman & Robert W. Becker, *The New Basel II Capital Accord: Business and Legal Challenges for Real Estate Lenders*, 120 BANKING L.J. 309, 310 (2003) ("Capital is defined as consisting of Tier 1 and Tier 2.").

differences in the risk categories are not taken into consideration.¹⁴⁰ For instance, in the U.S., all commercial loans are weighted at 100% and all residential loans at 50%.¹⁴¹ This is one of the motivating factors for Basel II's revised system, which accounts for the qualitative differences with great force.¹⁴²

Basel I assigned risk weights to each category, with a lower rating indicating the more credit-worthy and lower risk.¹⁴³ Zero percent risk weight included cash, gold, and bonds issued by OECD governments.¹⁴⁴ Twenty percent risk weight included bonds issued by agencies of the OECD governments, local governments, and insured mortgages.¹⁴⁵ Fifty percent risk weight included uninsured mortgages.¹⁴⁶ One hundred percent risk weight included all corporate loans and claims by non-OECD banks, and government debt, equity, and property.¹⁴⁷ Key to this Article, "[o]ff-balance sheet instruments (e.g. *letters of credit*, futures, swaps, forex arrangements) were converted into 'credit risk equivalents', and weighted by the type of counterparty to a given claim. Again, OECD government counterparties receive a 0% weight; 20% for OECD banks and public sector agencies."¹⁴⁸

3. Eight Percent Capital Requirement

The Basel Accord subjects banks to an 8% capital requirement, which requires the capital divided by the credit risk to measure greater than 8%.¹⁴⁹ This

¹⁴⁰ See, e.g., FRB Capital Standards for Banks, *supra* note 103, at 396 ("As implemented in the United States, [Basel I] specifies only four levels of risk, even though loans assigned the same risk weight (for example, 100 percent for commercial loans) can vary greatly in credit quality.").

¹⁴¹ *Id.*

¹⁴² See Dwight C. Smith III, *Basel II: An Update*, BANK ACCT. & FIN., Feb. 1, 2004, at 27.

¹⁴³ HEFFERNAN, *supra* note 70, at 182.

¹⁴⁴ *Id.*

¹⁴⁵ *Id.*

¹⁴⁶ *Id.*

¹⁴⁷ *Id.*

¹⁴⁸ *Id.* (emphasis added).

¹⁴⁹ Basel Committee on Banking Supervision, *supra* note 6.

requirement represents an indicator of a bank's financial strength, and many institutions exceed this minimum. Of that 8%, a minimum of 4% must be from Tier I capital.¹⁵⁰

For example, "if a bank has assets in the form of U.S. Treasury bonds worth \$100, the capital charge required for those assets is zero."¹⁵¹ This is because government bonds are given a risk weight of 0%.¹⁵² "If, alternatively, a bank has assets in the form of corporate bonds worth \$100, the capital charge required is equal to \$8, of which at least \$4 must be in Tier 1 capital."¹⁵³ This is because corporate loans and bonds are weighted at 100%,¹⁵⁴ therefore, one must calculate the 8% requirement from the full amount of the bond, in this case \$100. So, \$8 is required to be held as a capital charge, \$4 of which must come from Tier 1 capital. The Basel system is based on the idea that having reserve capital requirements will lessen the likelihood of panic, contagion, and bank failure.

4. Off-balance Sheet Items

Off-balance sheet items include letters of credit and other transactions that banks carry on as part of their daily business.¹⁵⁵ These are given the risk-weights of "100 percent for instruments that substitute for loans, such as standby letters of credit; 50 percent for transaction-related contingencies, such as standby letters of credit for a particular transaction; and 20 percent for short-term, self-liquidating trade-related contingent liabilities, such as commercial letters of credit."¹⁵⁶ So, a commercial letter of credit worth \$100 is a 20% risk-weighted asset. Eight percent of \$20, or \$1.60, is the capital charge required. A stand-by letter of credit for \$100

¹⁵⁰ Rodríguez, *supra* note 12, at 8.

¹⁵¹ *Id.*

¹⁵² *See id.* at 8, tbl. 1.

¹⁵³ *Id.* at 8-9.

¹⁵⁴ *See id.* at 8, tbl. 1.

¹⁵⁵ *See* Wikipedia, Off-balance-sheet, <http://en.wikipedia.org/wiki/Off-balance-sheet> (last visited Nov. 9, 2006) ("Off balance sheet usually means an asset or debt or financing activity not on the company's balance sheet. It could involve . . . a contingent liability such as a letter of credit.").

¹⁵⁶ Rodríguez, *supra* note 12, at 8 tbl. 1.

would have a risk-weight of 50%, so the capital charge would be eight percent of \$50.

B. Evening the Playing Field

Through Basel I, the Basel Committee sought to bring greater stability to the financial world.¹⁵⁷ It also hoped to provide a more even playing field.¹⁵⁸ The benefit of a system like Basel I is that it is easy to figure out the rates. The capital charge of a stand-by letter of credit is a known quantity; that will not necessarily be the case under Basel II.

C. Basel Amendment 1996: The Addition of Market Risks

The 1996 amendment to Basel I added market risks to the equation. A market risk is defined as the risks (a) “in the trading book of debt and equity instruments and related off-balance-sheet contracts and (b) foreign exchange and commodities risks.”¹⁵⁹ The amendment “introduced a more direct treatment of off-balance sheet items rather than converting them into credit risk equivalents, as was done in the original Basel I.”¹⁶⁰ A Tier 3 capital was also added, which was defined as “short-term subordinated debt (with a maturity of less than 2 years), which meets a number of conditions stipulated in the agreement, including a requirement that neither the interest nor principal can be repaid if it results in the bank falling below its minimum capital requirement.”¹⁶¹ A bank could adopt either an internal model or

¹⁵⁷ Abhijit Ghosh, *Solution Framework for Credit Risk Under BASEL II*, BUS. CREDIT, Mar. 1, 2004, at 56. This is the same justification of Basel II as well. See, e.g., Susan Schmidt Bies Delivers Remarks on Current Banking Issues at The British Bankers’ Association 10th Annual Supervision Conference, FDCH CAPITAL TRANSCRIPTS, Oct. 11, 2006, available at 2006 WLNR 17587348 (“Basel II is intended to promote the stability of the U.S. financial system by ensuring the safety of and soundness of the largest U.S. banks.”); Ben Bernanke Delivers Remarks On Basel II at The Federal Reserve Bank Of Chicago’s 42nd Annual Conference on Bank Structure and Competition, FDCH CAPITAL TRANSCRIPTS, May 18, 2006, available at 2006 WLNR 8540694 (“It is important to keep in mind, however, that the core goal of Basel II is to promote the stability of the U.S. financial system by ensuring the safety and soundness of U.S. banks.”).

¹⁵⁸ Rodríguez, *supra* note 12, at 1.

¹⁵⁹ Basel Committee on Banking Supervision, Amendment to the Capital Accord to Incorporate Market Risks 1 n.2 (Jan. 1996), available at www.bis.org/publ/bcbs24.pdf.

¹⁶⁰ HEFFERNAN, *supra* note 70, at 186.

¹⁶¹ *Id.* at 187.

standardized model for determining its capital charge and market risk.¹⁶² Under the current Basel rules, more sophisticated banks may employ their own advanced risk models if the country regulator approves.¹⁶³

III. BASEL II

A. The Growing Need for Basel II

1. The Asian Financial Crisis

The Asian Crisis “in the Fall of 1998 was the first post-World War II crisis in which events in emerging market economies seriously threatened the financial stability of the West, and where the origins of the crisis were clearly to be found in the workings of liberalised markets and private sector institutions.”¹⁶⁴ Lord Eatwell explains,

The spark was the financial crisis that overwhelmed many of the Asian economies in 1997, and spread to Russia in 1998. But the centre of the conflagration was the near failure of the hedge fund Long Term Capital Management. More than any of the other problems in the Fall of 1998, the threats that LTCM’s difficulties posed to financial stability throughout the world illustrated beyond all reasonable doubt that the international financial system had entered a new era. This was not a problem of sovereign debt, or macroeconomic imbalance, or even a foreign exchange crisis. Instead it was the manifestation of the systemic risk created by the market driven decisions of a private firm.¹⁶⁵

¹⁶² *Id.*

¹⁶³ *Id.*

¹⁶⁴ John Eatwell, *The New International Financial Architecture: Promise or Threat?*, May 22, 2002, at 6, available at <http://www.cerf.cam.ac.uk/publications/files/Cambridge-MIT%20lecture%2022.5.pdf>.

¹⁶⁵ *Id.*

Some believe that the Asian crisis occurred in part because of Basel I.¹⁶⁶ Basel I encouraged short-term loans to other banks because it assigned a 20% risk-weight to short-term loans to banks, instead of the 100% risk-weight assigned to loans to non-banks.¹⁶⁷ This choice is believed to have contributed to the crisis, as Asian banks took advantage of the increased borrowing opportunities and the rest of the world took advantage of lending to banks.¹⁶⁸ “Sixty percent of the \$380 billion in international bank lending to Asia at the end of 1997 had a maturity of one year or less” because loans under a year in length required no capital need regulations.¹⁶⁹

2. Circumventing Basel I: Regulatory Arbitrage

The Asian financial crisis of 1998 is credited, in part, with creating the need for a revised Basel accord.¹⁷⁰ The fixed risk-weight scheme under Basel I also led to another consequence: banks began engaging in regulatory arbitrage.¹⁷¹ Regulatory arbitrage is defined as “using a financial instrument or transaction to reduce capital requirements without a corresponding reduction in the risk incurred.”¹⁷² The Asian bank crisis could be seen as an example of regulatory arbitrage.¹⁷³ William McDonough, president and CEO of the Federal Reserve Bank of New York and chairman of the Basel Committee on Banking Supervision explained, “One significant weakness is that the Accord’s broad brush structure may provide banks with an unintended incentive to take on higher risk exposures without requiring

¹⁶⁶ See, e.g., Rudi Bonte et al., *Supervisory Lessons to be Drawn from the Asian Crisis* 26-33 (Basel Comm. on Banking Supervision, Working Paper No. 2, 1999), available at http://www.bis.org/publ/bcbs_wp2.htm.

¹⁶⁷ Rodríguez, *supra* note 12, at 11.

¹⁶⁸ See *id.*

¹⁶⁹ *Id.*

¹⁷⁰ See Lee Hsien Loong, *Post Crisis Asia – The Way Forward*, ASIAN BANKER J., Oct. 4, 2000, available at <http://www.emcap.org/review/0011/sg2109.htm>.

¹⁷¹ See Patricia A. McCoy, *Musings on the Seeming Inevitability of Global Convergence in Banking Law*, 7 CONN. INS. L.J. 433, 450 (2001); *Bothersome Basel*, ECONOMIST, Apr. 17, 2004, at 5-8.

¹⁷² HEFFERNAN, *supra* note 70, at 185.

¹⁷³ Another example is called “cherry picking,” which “involves the holding of riskier assets within a given category.” Rodríguez, *supra* note 12, at 10.

them to hold a commensurate amount of capital.”¹⁷⁴ Basel II is supposed to end regulatory arbitrage because riskiness will be included as a factor in measuring the need of capital reserve, but some are not so sure.¹⁷⁵ Again, economists cite Basel I’s preference of equity over debt.¹⁷⁶ One economist concludes, “For a given perceived differential between the cost of equity and the cost of debt financing, incentives to take RCA [Regulatory Capital Arbitrage], therefore, are related *negatively* to the associated structuring costs, and *positively* to the extent to which RCA permits debt to be substituted for equity.”¹⁷⁷

3. Different Needs for Large International Financial Institutions

The U.S. Federal Reserve Board believes that Basel I works very well for most financial institutions.¹⁷⁸ It believes, however, that a new Basel accord is needed for more complex, large, financial institutions; it is to those institutions that Basel II is directed.¹⁷⁹ Because the art of risk management has evolved, Basel I’s crude system of four categories of risk-weighting should be replaced with a more sophisticated, more qualitative determination.¹⁸⁰ As the banking community has become increasingly concentrated, Basel I started seeming outdated.¹⁸¹ Big

¹⁷⁴ William J. McDonough, President and Chief Executive Officer, Fed. Reserve Bank of New York, *The Impact of Today’s Technology on Banking and the Financial Markets* (Sept. 20, 2000), *available at* <http://www.ny.frb.org/newsevents/speeches/2000/mcdon000920.html>.

¹⁷⁵ Rodríguez, *supra* note 12, at 15 (“As the Shadow Financial Regulatory Committee, a group of publicly recognized, independent experts on financial issues, stated in its comment on the New Basel Accord: ‘Although the task of computing the correct economic capital for a bank is very difficult and complex, bank capital regulation need not be. Indeed, greater complexity in bank regulation reduces transparency and may increase the scope for regulatory arbitrage and regulatory forbearance.’”) (quoting Statement of the Shadow Financial Regulatory Committee on The Basel Committee’s Revised Capital Accord Proposal 1-2 (Feb. 26, 2001), *available at* <http://www.bis.org/bcbs/ca/shfirect.pdf>).

¹⁷⁶ *See, e.g., id.* at 10.

¹⁷⁷ *Id.* (citing David Jones, *Emerging Problems with the Basel Capital Accord: Regulatory Capital Arbitrage Related Issues*, 24 J. OF BANKING & FIN. 39 (2000)).

¹⁷⁸ *See* FRB Capital Standards for Banks, *supra* note 103, at 396.

¹⁷⁹ *Id.*

¹⁸⁰ *Id.*

¹⁸¹ *Id.*

international banks want to use their own risk-management software and calculations to include riskier credit and other factors not used in Basel I.¹⁸²

B. The Imminent Arrival of Basel II

With the Asian financial crisis, the spread of regulatory arbitrage, and the development of sophisticated risk-management systems in large international banks, critics began to feel that Basel I was becoming outmoded. In 2001, a new proposal was introduced in the Basel Committee.¹⁸³ Comments from outside the elite group of the Basel Committee were encouraged, and the committee received over 250 responses.¹⁸⁴ The Basel Committee conducted three impact statements as well.¹⁸⁵ More changes were made to the agreement, and a new agreement was reached in May 2004.¹⁸⁶

Basel II significantly revises the concept of regulatory capital. "Future capital requirements are to be far more flexible, and more closely aligned to free market forces."¹⁸⁷ Moreover, the one-size-fits-all approach of Basel I has been replaced with a more complex mix-and-match system. There is great criticism of Basel II from a myriad of camps.¹⁸⁸ This Section tries to understand just what Basel II will do when it is finally implemented in 2007.

Whereas Basel I had a three-tiered system focused on capital, Basel II will have a three-pillar system, and although the change in name does not make it obvious, the ordering of Basel II is something distinctly new from the more

¹⁸² *Id.* at 397.

¹⁸³ Bank for International Settlements, Update on the New Basel Capital Accord, June 25, 2001, <http://www.bis.org/press/p010625.htm> (last visited Nov. 9, 2006).

¹⁸⁴ *Id.*

¹⁸⁵ Bank for International Settlements, Basel II: International Convergence of Capital Measurement and Capital Standards: a Revised Framework, June 2004, <http://www.bis.org/publ/bcbs107.htm> (last visited Nov. 9, 2006).

¹⁸⁶ Bank for International Settlements, Consensus achieved on Basel II proposals, May 2004, <http://www.bis.org/press/p040511.htm> (last visited Nov. 9, 2006).

¹⁸⁷ Eatwell, *Basel II*, *supra* note 8.

¹⁸⁸ *See, e.g.*, Rodríguez, *supra* note 12, at 14-17.

simplified Basel I agreement.¹⁸⁹ Minimum capital requirements continue to be the focus of Basel II, but their determination and monitoring is much more complex.¹⁹⁰

Basel II is different from Basel I in that it focuses on specific variables, rather than broad categories for determining credit risk.¹⁹¹ Just as the 1998 amendment expanded the formula to include market risks, Basel II goes significantly further in that direction. “The core idea of Basel II is that market disciplines, whether direct or mediated through banks’ own risk-modelling, should be placed at the heart of financial regulation.”¹⁹²

Does Basel II slide too close to the business of banks, rather than regulating them? We have seen this trend in other areas, including laws protecting the environment. When businesses that hurt the environment help write the regulations, the environment may not be the first focus of protection. Similarly, many are concerned that the regulations will not provide adequate protection in a banking crisis.¹⁹³ As Eatwell explains,

But the reason regulators exist is that markets don't always work efficiently to achieve society's goals. Just as the environmental watchdog is there because the market encourages polluting behaviour (imposing costs on society as a whole rather than the polluter), so the financial regulator is there because financial risk takers expose society to far greater losses than they might suffer themselves.¹⁹⁴

Pillar One concerns the core element of Basel I, namely determining how much regulatory capital a bank must have on hand.¹⁹⁵ The Tier 1 and 2 system

¹⁸⁹ Wikipedia, Basel II, http://en.wikipedia.org/wiki/Basel_II (last visited Nov. 9, 2006).

¹⁹⁰ Rodríguez, *supra* note 12, at 11.

¹⁹¹ Eatwell, *Basel II*, *supra* note 8; ICBA, Summary of Proposed Revisions to Basel I, <http://www.icba.org/advocacy/index.cfm?ItemNumber=16587&sn.ItemNumber=1710> (last visited Nov. 9, 2006).

¹⁹² Eatwell, *Basel II*, *supra* note 8.

¹⁹³ See, e.g., Statement of L. William Seidman, Basel II, November 10, 2005, at 4, *available at* http://www.senate.gov/~banking/_files/seidman.pdf.

¹⁹⁴ Eatwell, *Basel II*, *supra* note 8.

¹⁹⁵ FRB Capital Standards for Banks, *supra* note 103, at 398.

continues in Basel II, as does the 8% capital requirement.¹⁹⁶ The significant change comes in how to calculate the risk-weight for individual assets.¹⁹⁷ This will be based on a more complex calculation than anything seen in Basel I, even the 1998 amendment.

Under Basel II, there would be three options for measuring credit risk: one standardized approach and two internal-ratings-based approaches (“IRBs”).¹⁹⁸ The standardized approach continues with fixed risk-weighting categories (adding more categories), but adds a qualitative component through external credit ratings “to evaluate corporate risk exposures.”¹⁹⁹ The IRBs focus their analysis on the qualitative elements in greater proportion, and can be determined by the banks themselves.²⁰⁰ The more simplified IRB focuses on the probability of loan default, whereas in the more complex version, the bank would determine all of the risks associated with the particular transaction.²⁰¹

The benefit of the new system is that it will give weight to the qualitative differences in banks’ choices, rather than treating types of finance as blanket categories.²⁰² This is known as the IRB compliance, and is far more complicated than the Basel I formulas.²⁰³ For those who see this as a positive step,

[t]hese investments enable banks to realise more consistent profits and reduced volatility of credit losses by taking a structured and consistent view of risk management. Also, banks may actually realise

¹⁹⁶ Rodríguez, *supra* note 12, at 11.

¹⁹⁷ FRB Capital Standards for Banks, *supra* note 103, at 398.

¹⁹⁸ *Id.*

¹⁹⁹ *Id.*

²⁰⁰ *Id.*

²⁰¹ *Id.*

²⁰² *See id.*

²⁰³ *See id.*

an increase in profits in the form of lower provisions, consistent risk spreading, more effective deployment of capital and loss avoidance.²⁰⁴

Some believe that this will lead to better decisions on the day-to-day level of the bank, because the new system rewards quality, rather than merely quantity: “differentiating risk on an asset-by-asset level adds transparency to the credit decision-making process and empowers better economic decision making.”²⁰⁵ On a second level, some see Basel II as leading to greater consistency within a bank’s internal risk systems.²⁰⁶

There is also a new charge for operational risk that is factored into the former 8% capital requirement.²⁰⁷ Operational risk is “defined as ‘the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events.’”²⁰⁸ The new formula includes credit risk + market risk + operational risk.²⁰⁹ The measurements for market risk remain the same as under the 1998 amendment.²¹⁰

Even the most enthusiastic recognize that Pillar One places new burdens on data acquisition and management when it is figured on a less standardized system.²¹¹

²⁰⁴ Jason Kofman, *Basel II: Laying the Groundwork*, THE BANKER, July 1, 2004, at 165 [hereinafter Kofman].

²⁰⁵ *Id.*

²⁰⁶ *Id.*

²⁰⁷ See Patrick de Fontnouvelle et al., *The Potential Impact of Explicit Basel II Operational Risk Capital Charges on the Competitive Environment of Processing Banks in the United States* 23 (Fed. Reserve Bank of Boston, Jan. 12, 2005), available at <http://www.federalreserve.gov/generalinfo/basel2/docs2005/opriskjan05.pdf>.

²⁰⁸ Rodríguez, *supra* note 12, at 11; see also Mamiko Yokoi-Arai, *The Evolving Concept of Operational Risk and Its Regulatory Treatment*, 9 L. & BUS. REV. AM. 105, 107 (2003) (“[Operational risk] is generally defined as ‘the risk of losses resulting from inadequate systems, controls or human error.’”) (quoting Group of Thirty, *Global Derivatives: Practices and Principles* (July 1993)) [hereinafter Yokoi-Arai].

²⁰⁹ Yokoi-Arai, *supra* note 208, at 107.

²¹⁰ *Id.*

²¹¹ See Kofman, *supra* note 204, at 165.

In part, this is probably why the Basel Committee felt the need to add two additional pillars.

Pillar Two concerns banking supervision, which sets out “four key supervisory principles.”²¹² The supervisors are supposed to encourage development of internal methods of assessing capital and control methods.²¹³ Supervisors are also supposed to intervene as soon as possible if bank levels of capital dip below the 8% capital requirement.²¹⁴ There are no specific directions given on how supervisors are supposed to accomplish these tasks.²¹⁵

Pillar Three focuses on “market discipline enforced by greater disclosure of banks’ financial status and their internal risk management procedures.”²¹⁶ Banks must disclose risk exposure, capital adequacy, methods for computing capital requirements, and any additional material information.²¹⁷ Disclosure is to take place twice a year, and quarterly if there is risk exposure, particularly if the bank is involved in global activities.²¹⁸

C. The Practical Impact of Basel II: A Two-Tiered System Replaces a Level Playing Field

Basel I created a system whereby large and small international banks all configured their capital on the same scale.²¹⁹ Some, including the Basel Committee,

²¹² Rodríguez, *supra* note 12, at 14.

²¹³ *See id.*

²¹⁴ *Id.*

²¹⁵ *Id.*

²¹⁶ Eatwell, *Basel II*, *supra* note 8.

²¹⁷ *See generally* Bank for International Settlements, *Part 4: The Third Pillar – Market Discipline*, in *THE NEW BASEL CAPITAL ACCORD* 154 (2003) (describing the disclosure requirements under Basel II), available at <http://www.bis.org/bcbs/cp3part4.pdf>.

²¹⁸ HEFFERNAN, *supra* note 70, at 203.

²¹⁹ Some have called Basel a regulatory “imperialism” because a group of bankers created a standard, which was then adopted by the G-10 countries, whose banks then all followed the requirements. *See, e.g.*, Michael S. Barr & Geoffrey P. Miller, *Global Administrative Law: The View from Basel*, 17 *EUROPEAN J. OF INT’L L.* 15, 20 (2006) (“While the Basel standards were intended only to apply to internationally

believed this would help create a more level playing field.²²⁰ Basel II does away with this notion entirely.²²¹ Moreover, unlike Basel I, not everyone is poised to adopt the new standards. In fact, the U.S. has decided that only its top ten international banks will be required to adopt Basel II, with an additional ten having the option to choose between Basel I and Basel II.²²² As the Federal Reserve explained,

Basel I was a major step forward in capital regulation. Indeed, for most banks in this country, Basel I is now—and for the foreseeable future will be—more than adequate as a capital framework. . . . Basel I is too simplistic to adequately address the activities of our most complex banking institutions.²²³

But Basel II does not come without concern. Some worry Basel II creates a complicated system that brings a false sense of security.²²⁴ Alan Greenspan worried that foreign banks would claim they have proper risk management systems in place,

active banks in the G-10, the 1988 Accord was quickly applied to all banks in the G-10, and over 100 other countries ‘voluntarily’ adopted the accord.”); *see also* Testimony of Jim Garnett on Behalf of the American Bankers Association before the Committee on Banking, Housing and Urban Affairs of the United States Senate, September 26, 2006, at 5, *available at* <http://www.aba.com/NR/rdonlyres/222CE044-577A-11D5-AB84-00508B95258D/44460/GarnettSenateTestimonyfinalSept262006.pdf>. He concludes his testimony, “The initiative to improve existing capital rules could impose burdens that far outweigh its benefits.” *Id.* at 8. But he is also not advocating a one-size fits all system: “It is important that risk and capital be appropriately linked for all banks regardless of their size, and in such a way as to avoid creating competitive disparities.” *Id.*

²²⁰ *See* Remarks by Roger W. Ferguson, Jr. at the ICBI Risk Management 2003 Conference, Geneva, Switzerland, December 2, 2003, <http://www.federalreserve.gov/BoardDocs/Speeches/2003/20031202/default.htm> (last visited Nov. 9, 2006).

²²¹ Testimony by James H. McKillop, U.S. House of Representatives Committee on Financial Services, A Review of Regulatory Proposals on Basel Capital and Commercial Real Estate, September 14, 2006, at 13, *available at* <http://www.icba.org/files/ICBASites/PDFs/test091406.pdf>.

²²² *See* Testimony of Vice Chairman Roger W. Ferguson, Jr., U.S. House of Representatives, Basel II, before the Subcommittee on Domestic and International Monetary Policy, Trade, and Technology, Committee on Financial Services, February 27, 2003, <http://www.federalreserve.gov/boarddocs/testimony/2003/200302272/default.htm> (last visited Nov. 9, 2006).

²²³ *Id.*

²²⁴ Credit Suisse Group, The New Basel Capital Accord, Consultative Paper of Jan. 16, 2001, at 5 (May 30, 2001), *available at* <http://www.bis.org/bcbs/ca/cresuigro.pdf> [hereinafter The New Basel Capital Accord].

when in actuality they too were far from prepared.²²⁵ This is particularly worrisome, since the IRB systems help determine the capital charges themselves.

1. The IMF and the World Bank

The IMF increasingly views itself as a financial regulator.²²⁶ After the 1997/1998 financial crisis, the IMF and the World Bank set up a new worldwide Financial Sector Assessment Program (“FSAP”).²²⁷ Moreover, the IMF has plans for implementing Basel II around the world.²²⁸ One commentator worries, “Handing financial regulation back to ‘market discipline’ will nullify the progress that has been made to create a system of international regulation.”²²⁹

2. Benefits May Fall Short

Some commentators think that while the measuring of regulatory capital will be far more complex, the new system does not necessarily promise to be any more accurate.²³⁰ For developing countries, some believe Basel II will detrimentally affect lending “as a consequence of . . . lending to lower rated borrowers.”²³¹ Others predict that those who do adopt Basel II will spend an enormous amount figuring out the capital requirements, reducing any benefit Basel II might have brought

²²⁵ See Remarks by Chairman Alan Greenspan at the Conference on Bank Structure and Competition, Federal Reserve Bank of Chicago, Chicago, Illinois, May 10, 2002, <http://www.federalreserve.gov/boarddocs/speeches/2002/20020510/default.htm>.

²²⁶ See Eatwell, *Basel II*, *supra* note 8.

²²⁷ *Id.*

²²⁸ *Id.*

²²⁹ *Id.*

²³⁰ See, e.g., Stephany Griffith-Jones, Miguel Angel Segoviano & Stephen Spratt, *Basel II and Developing Countries: Diversification and Portfolio Effects* 11 (Dec. 2002), available at http://www.stephanygj.com/_documents/Basel_II_and_Developing_CountriesDiversification_and_Portfolio_Effects.pdf.

²³¹ *Id.*

them.²³² “Indeed, the Credit Suisse Group estimates compliance costs at an average of \$15 million per bank for about 30,000 banks worldwide.”²³³

The hope is that the IRB model will result in lower capital charges, but at what price? Moreover, Basel II requires that the regulatory capital cannot be decreased very rapidly from the Basel I requirements. A bank must keep the current minimum of at least 90% of the Basel I standard for the first year and 80% for the second year.²³⁴ This is in contrast to the extensive costs associated with implementing the new system. Basel II also requires greater supervision and regulatory oversight, something that was not as necessary with the Basel I system.²³⁵

3. And What About in a Crisis?

Many are predicting that Basel II will work just fine in day-to-day operations, but once a crisis hits, the new regulatory system will only increase risks, losses, and panic, rather than stabilizing the financial and social environment.²³⁶ One person predicting danger with Basel II is Lord John Eatwell, Director of the Cambridge Endowment for Research in Finance.²³⁷ He sees three problems with Basel II and its creation of a more risky world.²³⁸ He explains that this is because the internal risk management systems of individual firms are extremely sensitive to changes in the market.²³⁹ Eatwell explains and predicts,

²³² See, e.g., Ernst & Young, Global Basel II Survey: Basel II: The Business Impact 7 (2006), available at [http://www.ey.com/global/download.nsf/Ireland/Basel_II_Survey/\\$file/Basel%20II%20Survey.pdf](http://www.ey.com/global/download.nsf/Ireland/Basel_II_Survey/$file/Basel%20II%20Survey.pdf) ; The Economist Intelligence Unit, Weighing Risk: Basel II and the challenge for mid-tier banks 13 (2004), available at http://www.oracle.com/industries/campaigns/finsrv/oracle_ciu_baselii.pdf.

²³³ Rodríguez, *supra* note 12, at 3 (citing The New Basel Capital Accord, *supra* note 224, at 7).

²³⁴ *Id.* at 16.

²³⁵ *Id.* at 15.

²³⁶ See, e.g., Eatwell, *Basel II*, *supra* note 8.

²³⁷ See Cambridge Endowment for Research in Finance, Professor Lord Eatwell, http://www.cerf.cam.ac.uk/staff/index.php?current=3&staff_id=5 (last visited Nov. 9, 2006).

²³⁸ See Eatwell, *Basel II*, *supra* note 8.

²³⁹ *Id.* For more on Lord Eatwell, please see www.cerf.cam.ac.uk.

Good risk managers hold a portfolio of assets that are not volatile and the prices of which are not highly correlated—not correlated in normal times that is. But in a crisis the volatility of a given asset may rise sharply. The models will tell all firms to sell. As all try to sell, liquidity dries up. As liquidity dries up, volatility spreads from one asset to another. Previously uncorrelated assets are now correlated in the general sell-off, pumped up by the model driven behaviour of other institutions caught in the contagion. So whilst in normal times models may encompass a wide range of behaviour, in extreme circumstances they will encourage firms to act as a herd, charging toward the cliff edge together.²⁴⁰

Eatwell further explains,

[T]he emphasis on disclosure reduces the diversity of information that has in the past created diversity of action. Today, information is ever more readily available, and disclosure of price sensitive information is legally required. Insider dealing on private information is, rightly, characterised as market abuse. But the attainment of equal information is bought at a cost - increased likelihood of herd behaviour as all react in the same way to the same news.²⁴¹

Eatwell also believes that a herding mentality will act in the wrong way during a crisis: “So, in extremis, when regulation really matters, it will work the wrong way, reinforcing destabilising behaviour.”²⁴²

IV. ARE WE ENTERING THE POSTMODERN ERA OF INTERNATIONAL FINANCIAL REGULATION?

Basel II is typically viewed as reflecting the increasing complexity within the global financial markets. Because of the Asian Crisis and its aftermath in 1997 and 1998, and increased regulatory arbitrage, a more complex agreement was needed than Basel I and the 1998 amendments. Is it possible to place this shift in need and

²⁴⁰ Eatwell, *Basel II*, *supra* note 8.

²⁴¹ *Id.*

²⁴² *Id.*

response within a larger theoretical context?²⁴³ Might we see these developments as a movement from a modern to a postmodern system of banking?

A. The Differences between Pre-modernism, Modernism, and Postmodernism

This Article began with a reference to George Bailey's bank-related troubles in *It's a Wonderful Life*. The banking system represented in that film can be seen as something of a precursor to the modern banking world, which is to say a precursor to Basel I. This Section explores Bailey's pre-modern bank, and what Bailey's world would look like in a modern Basel I and a postmodern Basel II context, to better understand just what changes are occurring on a socio-cultural scale. This Section argues that Basel II, while commonly viewed as reflecting an increasingly complex globalized financial world, can also be seen as reflecting a postmodern socio-cultural condition. And if we understand the cultural milieu that we inhabit, we can better confront the shortcomings and praise the inventiveness of the era. In short, how should we culturally conceptualize the development of Basel I and Basel II in the late twentieth and early twenty-first centuries?

It is notable that the crisis that George faces is entirely local. In fact, it is the local nature of the crisis that provides the dramatic foundation for the film's pathos. George believes himself to be alone, facing off against an opponent with far greater economic resources than George could hope to muster. It is the town, his friends and neighbors, that ultimately comes to his rescue. In the end, George is "the richest man in town" because his immediate social relations provide a means for combating the financial threat that he faces. In this manner, his social relations take on greater significance than his financial standing.

George's experience, and the lesson he takes away from it, is only possible within a pre-modern banking system. Mr. Potter's attempt to foreclose and take over George's savings and loan affects only the two individual institutions and those with deposits in George's savings and loan. While this may impact those individuals who invested in George's savings and loan, there is no suggestion that such an occurrence would translate into any sort of crisis touching other financial institutions. The condition of financial affairs has changed radically over the course of the twentieth century as banking and financial practices have grown increasingly national and international in character.

²⁴³ For others working on the subject of Basel from a more theoretical perspective, see, e.g., Ethan B. Kapstein, *Supervising International Banks: Origins and Implications of the Basle Accord*, ESSAYS IN INT'L FIN., no. 185, (1991); Thomas Oatley & Robert Nabors, *Redistributive Cooperation: Market Failure, Wealth Transfers, and the Basle Accord*, 52 INT'L ORG. 35 (1998).

As noted above, the profound changes in the organization of production, distribution, and consumption through the course of and following World War II can be seen, in retrospect, as the culmination of “Fordist” practices (named after the automobile giant Henry Ford) dating back to innovations initiated in the early periods of the twentieth century.²⁴⁴ Only with institutionalization, through the post-World War II Bretton Woods system, could a stable version of these financial arrangements be propagated on a global scale. With the U.S. domination of the West, financially and otherwise, following World War II, this financial regime held for several decades, bringing along with it a maturation of the international banking system. Ironically, the very developments bringing it to maturation also sowed the seeds of the Bretton Woods system’s collapse in the early years of the 1970s. The modern banking system had become truly global by this time and, as other elements fatally fractured the overall financial system that was in place, the first instances of bank failures threatening to swamp interconnected institutions with similar crises was experienced.

Basel I, conceptualized as operating within a modern configuration of international banking, reflects a modernist approach to solving problems within and among financial institutions. Bretton Woods sought global stability through the institutionalization of international financial controls underpinned by U.S. hegemonic dominance. In spite of the increasingly complex global financial conditions appearing in the aftermath of the Bretton Woods collapse, the approach Basel I took in response to this crisis proved similarly modernist in perspective. Like Bretton Woods, Basel I embraces a modernist belief that greatest stability can be achieved through a centralized authority deploying a controlled solution throughout the system. Even more significant than centralization, however, is the belief under Basel I, originated in the attempt to prevent the occurrence of another Herstatt Debacle, that a universal, one-size-fits-all system could be formulated that would adequately regulate all of the international banks in the same manner.

In contrast, Basel II moves beyond a modernist paradigm in a number of ways. Though its formulation has been centrally organized, Basel II is a complex, convoluted, individualized system that may or may not work to achieve its goals of capital stability. There is not the same confidence in the plan. Moreover, even the design of the agreement reflects a postmodern multivalent chorus of interests and concerns, with over 250 comments from outside of the committee dramatically altering the final product. The mix-and-match approach to determining a bank’s regulatory capital also reflects a postmodern consciousness. There is no attempt to fit all banks into a universal system; many banks will not even opt into Basel II. It

²⁴⁴ See HARVEY, *supra* note 22, at 124.

reflects our world today, wherein one agreement to fit the problem is no longer recognized as a viable goal.

And where does this lead us in looking at Basel I and Basel II? These documents are a reflection of our times, demonstrating not only the needs of banking institutions to ward off crises, but also how we conceive the structure of the world. Neither Basel I nor Basel II would have been structured as a solution to George Bailey's problems. And what of George Bailey in the twenty-first century? If his small savings and loan still existed and had not been consolidated into a larger, international banking institution, he would not have to implement Basel II. But he might be worried that the large international banks would now have an even greater advantage with IRBs instead of a standardized method of determining regulatory capital. And his foe, his contemporary Mr. Potter, likely would cast a far wider shadow, now in the form of the international bank. George also might worry that the uneven playing field would become insurmountable under Basel II. He might be grateful that his system of determining the 8% capital requirement is still relatively easy and not too costly, since he would still be operating under Basel I. But he also would know that in some way he was being left behind, as the world moved from a straightforward, modernist framework—fearful of the world coming apart—to a postmodern framework—embracing differences, chaos, and even potential failure in favor of individuality, potential profit, and the greater complexities that comprise our postmodern world.