ARTICLE

Sovereignty and Legitimacy in International Banking Law

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In the United States, as elsewhere around the globe, the prudential regulation of large banks is based on standards promulgated by the Basel Committee on Banking Supervision (BCBS or Basel Committee). In this transnational organization, bank regulators from leading jurisdictions come together to agree to highly detailed and prescriptive standards for large, internationally active banks. National implementations of the Basel rules and standards typically differ from the BCBS standard in only minor ways. For example, U.S. regulators tend to deviate little from what was decided in Basel in the interest of international cooperation. And when the United States does deviate from Basel, it usually does so by "gold-plating." The legitimacy of this rule-making process recently came under intense scrutiny when U.S. bank regulators proposed controversial regulations intended to complete the post-2008 rule-making package known as Basel 3 in July 2023. The substantive and procedural shortcomings with the proposed Basel 3 (so-called) "endgame" rule have shined a light on long-standing flaws with the legal and democratic legitimacy of the Basel regime.

Arguably, the BCBS now encroaches on the sovereignty of its participating member states. This Article critically examines bank prudential rule-making at the Basel Committee and the domestic mechanisms of implementing the Basel rules, thus highlighting the separate but interacting deficiencies in each process. The Article ultimately proposes remedies for enhancing the legitimacy of the prudential regulation of banks in the United States and reconciling the needs of international cooperation in banking law with regulatory sovereignty.

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I. INTRODUCTION

The vast majority of rules, standards, and requirements that apply to U.S. banks have their genesis in an informal source of international regulation created in Basel, Switzerland.[1] Specifically, the Basel Committee on Banking Supervision (BCBS or Basel Committee) sets global standards for the prudential (i.e., safety and soundness) regulation of all large banks.[2] Its rules are then implemented in jurisdiction-specific, domestic regulations.[3] These regulations are grouped into numbered 'Accords.'[4] The most recent Accord, Basel 3, was developed from 2011 to 2019 in response to the 2008 global financial crisis.[5]

This Article argues that the current rule-making approach, whereby a consensus is formed in Basel and then Basel-made rules are implemented locally, is legally problematic when examined from both global and U.S. law perspectives. Not only is it unclear that the benefits of a negotiated global standard always outweigh the drawbacks associated with rules that are not tailored to the banking system to which they apply, but there are also substantial procedural issues in both the BCBS process and in the subsequent U.S. rule-making that implements the Basel standard.

The rules completing Basel 3's implementation in the United States were still under development in 2024.[6] These "Basel 3 endgame" proposals,[7] as

1. *See generally* CHARLES GOODHART, THE BASEL COMMITTEE ON BANKING SUPERVISION: A HISTORY OF THE EARLY YEARS, 1974–97 (2011) (providing an account of the Basel Committee's foundation and its first steps towards becoming a global bank rule writer).

2. *Id.* at 41–47, 307–12.

3. *Id.* at 181.

4. *Id.*

5. The components of Basel 3 range from BCBS, BASEL III: A GLOBAL REGULATORY FRAMEWORK FOR MORE RESILIENT BANKS AND BANKING SYSTEMS (2010), https://www.bis.org/publ/bcbs189_dec2010.pdf, [hereinafter INITIAL BASEL 3 PACKAGE], to BCBS, LEVERAGE RATIO TREATMENT OF CLIENT CLEARED DERIVATIVES (2019), https://www.bis.org/bcbs/publ/d467.pdf.

6. Regulatory Capital Rule: Large Banking Organizations and Banking Organizations With Significant Trading Activity, 88 Fed. Reg. 64028, 64168 (proposed Sept. 18, 2023) (to be codified at 12 C.F.R. pts. 3, 6, 32, 208, 217, 225, 238, 252, 324) [hereinafter the U.S. Endgame Proposal].

7. The "endgame" terminology appeared shortly after the Basel Committee announced the finalization of the Basel 3 reforms in December 2017. *See, e.g.*, *'Basel IV': Big Bang—or the Endgame of Basel III?*, PWC, at 1 (Dec. 2017), https://www.pwc.com/gx/en/financial-services/assets/basel-iv-big-bang.pdf.

they have become known, have become hugely controversial. For example, JPMorgan Chase's chief executive, Jamie Dimon, warned that they risked making bank stocks uninvestable and would result in borrowers paying more for loans.[8] Members of the U.S. House Financial Services Committee recommended that the proposal be withdrawn,[9] and, in response, Federal Reserve Board Chairman Jerome Powell admitted that "broad and material changes" were needed.[10]

This is an extraordinary situation for something as important as bank regulation. In this Article, we uncover the genesis of what is, at its core, a legitimacy problem with an international institution that has evolved outside the norms of public law. This led to an inherently flawed design of the BCBS regime itself, which has now crystalized in the development of Basel 3. Overall, the flawed Basel regime has led to a body of banking rules that are overly burdensome to regulated firms and hence create unnecessary costs for the real economy. Moreover, these rules are arbitrary, poorly justified, often based on political compromise rather than optimal design, sometimes disproportionate, developed in contradiction with the legal requirements for regulatory action, and largely unresponsive to criticism or evidence.

This Article uses administrative law as a tool to probe these issues. In the case of the Basel Committee, an analysis based on global administrative law reveals a lack of transparency, the failure to demonstrate rationality, and a lack of accountability and due process. The implementation of the Basel Accords by U.S. federal agencies, without detailed analysis of their costs and benefits for the banks to which they are applied and for the U.S. financial system as a whole, suggests that U.S. administrative law requirements may not be met either. The U.S. authorities' expected decision to withdraw and re-propose the rule highlights these agencies' need to hew more closely to administrative law requirements in bank regulations and the extent to which the transnational rule-making carried out by the BCBS may hinder that goal. Ultimately, we suggest that it is necessary to reform the rule-making process at the BCBS level to increase compliance with global administrative law norms and at the federal agency level to ensure proportionality and encourage appropriate tailoring.

In undertaking this analysis, this Article breaks new ground in the study of the Basel process and its outputs. Although administrative law scholars

8. Joshua Franklin et al., *Jamie Dimon Warns Investors Over Bank Stocks if US Capital Rules Enacted*, FIN. TIMES (Sept. 11, 2023), https://www.ft.com/content/ccd0f68c-2543-4e02-bbbc-0101d04609e1.

9. Letter from Patrick McHenry, Chairman, U.S. House of Representatives Comm. on Fin. Servs., et al., to Jerome H. Powell, Chairman, Bd. of Governors of the Fed. Rsrv. Sys., et al. (Mar. 5, 2024), https://financialservices.house.gov/uploadedfiles/2024-03-05_fsc_gop_letter_to_powell_gruenberg_hsu_on_basel_iii_endgame.pdf.

10. Christopher Rugaber, *Fed's Powell: Rate Cuts Likely This Year, but More Evidence Is Needed that Inflation Is Tamed*, ASSOCIATED PRESS (Mar. 6, 2024, 1:22 PM), https://apnews.com/article/inflation-rates-cuts-economy-federal-reserve-powell-d7ea4854d0e21feeb28f7891a1447d70.

have previously undertaken reviews of the global governance regime of financial regulation,[11] no scholarly work to date has scrutinized this closely the inner workings of the Basel regime while also tracing its historic evolution and assessing its work against global and U.S. legal norms. Our critical analysis adds a new viewpoint to the global financial regulation literature, the bulk of which gives transnational regulatory bodies a favorable assessment.[12]

There are significant stakes involved in critiquing the Basel process, even with the goal of offering constructive ideas for reform, as they are so deeply embedded in bank regulation. Moreover, the design, structure, process, and incentives of the Basel regime make it such that capital rules for banks are a one-way ratchet and often take dramatic steps upward in ways that impose significant economic costs and thus ultimately introduce costs into society. Therefore, in the wake of one of the most significant amplifications of the Basel rules in its history, the time is ripe to revisit the purpose and legitimacy of this international institution.

To that end, this Article proceeds in three parts. Part II provides a detailed overview of the Basel approach to bank regulation. Part III sets out our legal and rule-of-law concerns with the Basel Committee—first explaining how the BCBS parts ways with the norms of global governance, thus undermining the credibility of the global governance project overall, and then discussing its shortcomings from a U.S. law perspective. Part III uses the Basel 3 endgame rule to illustrate these problems, especially in the U.S. law dimension. Part IV discusses recommendations for reforming prudential regulation paradigms and processes.

II. THE BASEL FRAMEWORK FOR BANK PRUDENTIAL REGULATION

The importance of the Basel Committee for the regulation of banks is hard to overstate.[13] Most large and many smaller banks are subject to rules that are direct or very close transpositions of those originally written in

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11. *See, e.g.*, CHRIS BRUMMER, SOFT LAW AND THE GLOBAL FINANCIAL SYSTEM: RULE MAKING IN THE 21ST CENTURY (2012) (providing a descriptive account of how international financial rules are made through a variety of international soft law bodies); David Zaring, *Sovereignty Mismatch and the New Administrative Law*, 91 WASH. U. L. REV. 59 (2013) (concluding that international policy norms may impinge on some domestic law administrative law norms).

12. *See, e.g.*, DAVID ZARING, THE GLOBALIZED GOVERNANCE OF FINANCE i (2020) (concluding, in his study of a range of soft law financial regulatory bodies, that they create a "well-ordered and functioning regulatory environment: the international financial system enjoys a substantial degree of compliance, and operates predictably and harmoniously"). For the genus of the account presented here, see DAVID MURPHY, DERIVATIVES REGULATION: RULES AND REASONING FROM LEHMAN TO COVID 23, 229–52 (2022).

13. As Brett McDonnell puts it, "capital regulation [which is very largely determined by the Basel Committee] has become a centerpiece of bank regulation." Brett H. McDonnell, *The Promise and Perils of Top-down Capital Regulation*, 55 WASHBURN L.J. 385, 386 (2016).

Basel.[14] This Part explains, in historical context, how the BCBS established an authoritative regime of prudential regulation for internationally active banks.

A. *The Prudential Regulation of Banks from 1988 to 2008*

We begin with a sketch of the development of the Committee's role from its foundation to the global financial crisis in 2008. This encompasses two major rounds of rule-writing, the Basel 1 and Basel 2 Accords. These regulations are essentially requirements for banks to have sufficient resources of various kinds given regulators' assessment of the magnitude of the risks that they run, as outlined below.

It is also important to situate the Basel Accords in a broader context, which this Section does through a discussion of the rule-writing process, the implementation of BCBS rules in national law, the Committee's accountability, and its status. This material will form the background for an analysis of the issues with the Basel 3 endgame in later Parts.

1. *The History of and Motivations for the Formation of the Basel Committee*

While financial institutions' activities stretch across borders, each institution is based in a single country, and regulatory authority is primarily vested in national authorities. For large banks in the United States, these authorities are principally the Federal Reserve (Fed), the Office of the Comptroller of the Currency (OCC), and the Federal Deposit Insurance Corporation (FDIC). However, the financial systems that these bodies oversee can be affected by events outside the United States.[15] Indeed, some financial crises, such as that of 2008, influenced economies across the globe. Since cross-border financial flows are large and it is relatively easy for some banks to lend outside their home country, there is a danger that a relatively

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14. For a refreshing perspective opposing the "prevailing wisdom" that this is a good idea, see Roberta Romano, *For Diversity in the International Regulation of Financial Institutions: Critiquing and Recalibrating the Basel Architecture*, 31 YALE J. REGUL. 1, 1–2 (2014).

15. A good example that helped to motivate the creation of the Basel Committee was the failure of Bank Herstatt in 1974. Herstatt had accumulated large foreign exchange positions. It failed late in the trading day, after it had received large Deutschemark inflows on physically settled USD/DEM positions, but before it had paid out on the dollar side. Herstatt's failure to make contractually required U.S. dollar payments left several New York correspondent banks with substantial losses and created turmoil in the (bank-dominated) foreign exchange market. This clearly evidenced that the supervision of foreign banks was relevant to financial stability in the United States. *See Managing Foreign Exchange Risk*, FED. RSRV. BANK N.Y., https://www.newyorkfed.org/financial-services-and-infrastructure/financial-market-infrastructure-and-reform/managing-foreign-exchange/ (last visited Mar. 20, 2025); Ben Norman, *BoE Archives Reveal Little Known Lesson from the 1974 Failure of Herstatt Bank*, BANK UNDERGROUND (June 24, 2015), https://bankunderground.co.uk/2015/06/24/boe-archives-reveal-little-known-lesson-from-the-1974-failure-of-herstatt-bank/.

lax jurisdiction could attract financial institutions to redomicile there.[16] If banks subject to lighter regulation become distressed, this could cause instability outside their home country. Thus, bank regulators are incentivized to cooperate and to create common standards. Cooperation also facilitates the sharing of best practices and reduces regulatory development costs.[17]

The Bank for International Settlements (BIS) is a key locus of transnational financial regulation. The origins of this institution lie in incentivizing states to adhere to their sovereign debt commitments, specifically in the mechanics of German reparations after the First World War.[18]

The BIS became a coordination mechanism for the prudential regulation of banks thanks to episodes of financial stress on both sides of the Atlantic. This began with the collapse of the Bretton Woods agreement in 1971 and continued through the 1973 stock market crash, the U.K. Secondary Banking Crisis of 1973–75, and the failure of a German bank with significant activities in the United States.[19] At this point, it had become clear that banking or sovereign debt crises in one country or bloc could easily spill over to other economies, given the extent of international capital flows. As a result, the BCBS was established by the central bank governors of the G10 at the end of 1974, based at the BIS.[20] In the United States, a wave of failures of both local banks and the branches of foreign banks in the late 1970s and early 1980s provided further motivation.[21] The initial mandate of the BCBS was determined by these concerns: it was intended to promulgate sound practices among bank supervisors and to facilitate international supervisory cooperation with regard to banks' foreign operations.[22]

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16. *See, e.g.*, Andrea Beltratti & Giovanna Paladino, *Basel II and Regulatory Arbitrage. Evidence from Financial Crises*, 39 J. EMPIRICAL FIN. 180 (2016).

17. For a critical discussion of the case for international cooperation in financial regulation, see Pierre-Hugues Verdier, *The Political Economy of International Financial Regulation*, 88 IND. L.J. 1405, 1407 (2013).

18. *History - Overview*, BANK FOR INT'L SETTLEMENTS, https://www.bis.org/about/history.htm (last visited Feb. 2, 2025).

19. This was Bank Herstatt. *See supra* note 15.

20. *See* GOODHART, *supra* note 1, at 42–45.

21. George Hanc, *The Banking Crises of the 1980s and Early 1990s: Summary and Implications*, 11 FDIC BANKING REV. 1 (1998).

22. *History of the Basel Committee*, BANK FOR INT'L SETTLEMENTS, https://www.bis.org/bcbs/history.htm (last visited Feb. 2, 2025).

2. *Basel 1 and Its Features*

One (but far from the only) determinant of bank safety is its capital: the more capital a bank has, the more losses it can absorb without failing.[23] The episodes of financial instability in the late 1970s and early 1980s convinced both U.S. and U.K. central banks that a higher standard of bank capital regulation was needed, and in 1987 they came to a bilateral agreement on common rules to set minimum levels of bank capital.[24] However, the increasing internationalization of banking meant that, if this agreement was going to be effective, the United Kingdom and the United States needed other countries to agree to their bank capital standard too.[25] Otherwise, there was a risk that they would simply lose their large banks to more accommodating jurisdictions.

The Basel Committee was the ideal body to coordinate these discussions. Negotiations began, based on the U.S./U.K. agreement, and they eventually resulted in the international Accord on bank capital known as Basel 1.[26] Capital rule writing became part of the Committee's mandate: it was charged with acting as the "primary global standard setter for the prudential regulation of banks."[27]

Basel 1 represented a sea change in the regulation of banks. Capital regulation became harmonized globally. Bank investors became comfortable using the ratio of a bank's capital to its risk—the 'capital

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23. Capital can be understood by considering a bank's balance sheet. The bank has assets, such as loans or securities, on one side and liabilities which fund them, including the firm's equity or capital, and debt, on the other. Balance sheets must balance. Therefore, if the value of the assets changes, the liability side of the balance sheet must change by the same amount. The value of debt is (ignoring minor accounting complexities such as debt valuation adjustments and new/maturing debt) fixed, so the item that changes is the capital. Profits become retained earnings and increase capital; losses deplete it. Larger amounts of capital can absorb larger losses before the bank becomes (balance sheet) insolvent. *See* JIHAD DAGHER ET AL., IMF STAFF DISCUSSION NOTE 16/04, BENEFITS AND COSTS OF BANK CAPITAL 4 (2016), https://www.elibrary.imf.org/downloadpdf/journals/006/2016/004/article-A001-en.pdf.

24. *See* Goodhart, *supra* note 1, at 149.

25. A major motivation behind the joint U.S./U.K. push for harmonization was the rapidly increasing size and reach of Japanese banks in the 1980s. Both jurisdictions were concerned that a Japanese banking crisis–which they viewed as a serious risk given the poor capitalization of Japanese banks at the time–could pose a threat to the global economy. Thus, "the financial superpowers" exercised "political pressure to try to get other countries to adhere to the [developing] international standards" as Kentaro Tamura puts it in his discussion of the hypothesis that political power hypothesis' explaining Basel Committee compliance. *See* Kentaro Tamura, *Challenges to Japanese Compliance with the Basel Capital Accord: Domestic Politics and International Banking Standards*, 33 JAPANESE ECON. 23, 26 (2005) (available at https://doi.org/10.1080/2329194X.2005.11045208).

26. *See* BCBS, INTERNATIONAL CONVERGENCE OF CAPITAL MEASUREMENT AND CAPITAL STANDARDS (1988), https://www.bis.org/publ/bcbs04a.pdf [hereinafter BCBS, INTERNATIONAL CONVERGENCE].

27. *The Basel Committee - Overview*, BANK INT'L SETTLEMENTS, https://www.bis.org/bcbs/index.htm (last visited Feb. 2, 2025) [hereinafter *Basel Committee Overview*].

ratio'—to compare institutions.[28] The management of the capital ratio became an increasingly important element of banks' strategy.[29]

The Basel Committee's origin in cooperation on supervisory issues caused by cross-border banking failures is reflected in the focus of Basel 1. It was designed for internationally active banks, not for banks in general.[30]

3. The Transposition of BCBS Rules into National Law

The Basel Committee is not a treaty-based organization. Therefore, as one of us has elsewhere argued,

> [I]ts standards have no force in public international law, and they are not automatically binding in the United States. Rather, the Basel Committee is a 'soft-law' institution—it is a club of central bankers [and bank supervisors] that agree to meet, brainstorm, and develop what they view to be the optimal minimum standards for capital in globally active banks.[31]

In order for these standards to become formal sources of domestic law, each member must implement them through their country's ordinary process for making public law. Notably, the Basel Committee requires that its members commit to implementing and enforcing its rules. Specifically, pursuant to Article 5 of the Basel Committee Charter, members agree to (1) "implement and apply BCBS standards in their domestic jurisdictions within the pre-defined timeframe established by the Committee;" (2) "undergo and participate in BCBS reviews to assess the consistency and effectiveness of domestic rules and supervisory practices in relation to BCBS standards;" and (3) "promote the interests of global financial stability and not solely national interests, while participating in BCBS work and decision-making."[32]

In the United States and in many other jurisdictions, such a commitment made by domestic bank supervisors to a conglomerate of foreign bank supervisors cannot tie the hands of the legislature. These standards are not

28. Basel 1 capital ratios were reasonably good predictors of bank safety before the advent of the capital optimization transactions, see *infra* Section II.A.5, although simpler indicators performed well too. *See* Arturo Estrella, Sangkyun Park & Stavros Peristiani, *Capital Ratios and Credit Ratings as Predictors of Bank Failures*, 2000 FED. RSRV. BANK N.Y. ECON. POL'Y REV. 33.

29. For comment from the time of the implementation of Basel 1, see Duncan E. Alford, *Basel Committee International Capital Adequacy Standards: Analysis and Implications for the Banking Industry*, 10 PENN. ST. INT'L L. REV. 189 (1992).

30. *See generally* well-ordered and functioning regulatory environment, BANK OF INTERNATIONAL SETTLEMENTS, REPORT TO THE GOVERNORS ON THE SUPERVISION OF BANKS' FOREIGN ESTABLISHMENTS 2 (1975), https://www.bis.org/publ/bcbs00a.

31. *See* Christina Parajon Skinner, *Financial Stability and Bank Agency Discretion*, 92 U. CHI. L. REV. 1, 30 (2025). This method of rule-writing continued and expanded, and there are now a number of transnational networks in various areas of financial regulation. These include the Committee on Payments and Market Infrastructure, the Financial Stability Board, the International Association of Insurance Supervisors, and the International Organization of Securities Commissions.

32. Basel Committee Charter art. 5. (available at https://www.bis.org/bcbs/charter.htm), 2013.

only not the product of a ratified treaty but, as will be further discussed, their formation is not at all subject to the scrutiny of democratically elected leaders.[33] Nevertheless, despite the BCBS' lack of legal mandate or democratic authority, it has historically been the case that the Basel standards set sticky defaults that almost always become transposed into binding domestic law.[34]

4. *The Form of Prudential Rules for Banks*

The prudential framework that applies to banks is composed of a number of features. The best-known example, not least because it appeared in Basel 1, is a capital requirement. It defines how much of a particular form of capital a bank must have, based on the risks the bank takes.[35] There are various forms of capital, ranging from common equity tier 1, the most expensive-to-source and highest quality kind, to total capital.[36] The capital requirement is formed by adding up sub-requirements for individual risks, such as market risk, credit risk and, more recently and controversially, operational risk.[37]

The prudential framework also includes other elements, such as those requiring that each bank's liquid assets, as defined by regulators, exceed an estimate of their cash outflows in stress.[38] Many key rules in the prudential framework can therefore be thought of as having three key components: (1) a definition of how much of a certain kind of *resource* a bank is considered to have; (2) a regulator-defined *measure* of a certain kind of potential losses; and (3) a *calibration* of the resource requirement based on the loss measure.

Thus, under Basel 1, total capital must exceed 8% of (what was originally) a credit risk measure known as risk-weighted assets.[39] The naïve account of the need for capital regulation is that it ensures that sufficient loss-absorbing resources are available, making banks more robust. Thus, the

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33. *See infra* Sections II.A.7 (describing oversight at the Basel level), III.B.2 (describing oversight of implementation in the United States).

34. The U.S. banking regulators have also implemented Basel 1, introduced in 1988, and Basel 2, introduced in June 2004. Congress does have the power to overturn rules before they take effect with a joint resolution of disapproval. *See* Congressional Review Act, 5 U.S.C. §§ 801–808 (1996), but note that that power has not been commonly used.

35. Jaime Caruana & Aditya Narain, *Banking on More Capital*, 25 FIN. & DEV. 24, 24 (2008).

36. BCBS, BASEL FRAMEWORK, CAP10 - DEFINITION OF ELIGIBLE CAPITAL (2020), https://www.bis.org/basel_framework/chapter/CAP/10.htm?inforce=20191215&published=20200605&tldate=20230219.

37. BCBS, BASEL FRAMEWORK, RBC20 - RISK-BASED CAPITAL REQUIREMENTS (2023), https://www.bis.org/baselframework/BaselFramework.pdf.

38. BCBS, BASEL FRAMEWORK, LCR10 - LIQUIDITY COVERAGE RATIO (2019), https://www.bis.org/basel_framework/chapter/LCR/10.htm [hereinafter BASEL FRAMEWORK, LCR].

39. BCBS, INTERNATIONAL CONVERGENCE, *supra* note 26, at 14.

story would go, a Basel 1 bank could suffer losses of up to 8% of the notional of its loan book[40] without becoming insolvent.

Two important things are missing from this account. The first is that capital adequacy must be disclosed.[41] Thus, as a Basel 1 bank slides from having more capital than its capital requirement to having less because of losses, the market becomes aware of this. Depositors flee, counterparties terminate relationships, and the bank is unable to issue new securities or obtain fresh funding.[42] Thus, banks often fail well before they have used the available capital. Moreover, supervisors typically require banks whose capital levels are close to their requirement to act to reduce risk or increase capital and intervene if a capital requirement is breached.[43] Required capital may therefore not be loss-absorbing on a going concern basis: only capital *above* the minimum is highly likely to be available to absorb losses.[44]

This in turn means that the question of the optimal level of bank capital[45] is not the same as that of the optimal level of bank capital requirements.[46] The socially optimal level of bank capital might well be

40. This assumes that the loans are all risk-weighted at 100% so their entire notional counts as a risk-weighted asset. *See* GOODHART, *supra* note 1, at 224–64 (detailing the risk weighting process).

41. This arises from U.S. Securities and Exchange Commission (SEC) rules. 17 C.F.R. pt. 211, Subpt. A (2020); 17 C.F.R. pt. 231, Int. Rel. Tbl. (2020); 17 C.F.R. pt. 241, Int. Rel. Tbl. (2020).

42. *See* David Murphy, *Maintaining Confidence* (London Sch. Econ. Fin. Mkts. Grp. Paper Series, Special Paper No. 216, 2012) (presenting an account of the key role of confidence in bank stability). This was emphasized by recent failure of Credit Suisse, a bank whose capital ratio was over 14% at the point of failure, compared to a regulatory minimum of 10%, but which had lost the confidence of the market. *See* Yvan Lengwiler & Beatrice Weder Di Mauro, *Global Lessons from the Demise of Credit Suisse*, CEPR (Sept. 4, 2023), https://cepr.org/voxeu/columns/global-lessons-demise-credit-suisse.

43. *See, e.g.*, FED. DEPOSIT INS. CORP., FORMAL AND INFORMAL ENFORCEMENT ACTIONS MANUAL: PROMPT CORRECTIVE ACTION (2022), https://www.fdic.gov/regulations/examinations/enforcement-actions/ch-05.pdf; 12 U.S.C. § 93(a) (1980); FED. DEPOSIT INS. CORP., APPLICATIONS PROCEDURE MANUAL: PROMPT CORRECTIVE ACTION (2019), https://www.fdic.gov/regulations/applications/resources/apps-proc-manual/section-12-pca.pdf.

44. In practice, regulatory intervention to restore capital ratios are variable both in terms of timing and the ratio banks are required to target. Note that, depending on the regulatory regime, the "minimum" level of bank capital required to continue as a going concern might be set by ratings agency requirements or the level which attracts sufficient confidence in the funding market rather than by regulation. *See* Julie Andersen Hill, *Bank Capital Regulation by Enforcement: An Empirical Study*, 87 IND. L.J. 645 (2012).

45. The question of optimal bank capital concerns the balance between bank safety (and thus the reduced probability of a financial crisis) and the cost of credit (and thus the capacity of the regulated financial system to support economic growth). Optimal bank capital requirements are different, as they are a floor for the amount of capital banks must have after losses in order to continue as a going concern without regulatory intervention. This flooring becomes particularly problematic after a crisis, when banks' capital has been eroded by losses: banks' desire to remain over the regulatory minimum reduces their ability to lend, and hence to help the economy recover. This dynamic was already evident under Basel 1 and it became more pronounced as capital requirements increased after 2008. *See* DAGHER ET AL., *supra* note 23, at 11; Eric A. Posner, *How Do Bank Regulators Determine Capital Adequacy Requirements?* (Coase-Sandor Inst. for L. & Econ., Working Paper No. 698, 2014), https://chicagounbound.uchicago.edu/cgi/viewcontent.cgi?article=2370&context=law_and_economics.

46. The mechanism by which banks reduce the supply of credit in order to meet higher capital requirements rather than raising new capital is well-understood: raising capital is uncertain, especially

higher than the level that banks would themselves choose,[47] given market constraints, but that does not mean that capital requirements should be set at that higher level.

5. Basel 2

The requirements in Basel 1 were crudely framed and relatively easy for most affected banks to achieve.[48] This was deliberate: it was important for the credibility of the new regulation that banks could easily calculate their requirement, and that adaptations to meet the new rules, whether through raising new capital or reducing risk, were typically unnecessary or, at worst, minor.[49]

By the early 2000s, the simplicity of Basel 1 had become problematic. Not only was a Basel 1 capital ratio a relatively crude and unreliable indicator of bank risk, but it had also become easily manipulable. The culprit was securitization. The risk-weighted asset associated with a loan under Basel 1 was a fixed risk weight (typically either 100% or 50%) times the notional.[50] Securitization and tranching allowed the total notional of a book of loans, and hence its associated contribution to risk-weighted assets, to be reduced dramatically, while most of its risk (and hence most of its return) was retained.[51]

In response to these issues, the BCBS constructed a new Accord.[52] This introduced a new, more risk-sensitive pair of approaches to calculating

in times of stress, and it can have adverse signaling effects. Therefore, banks often prefer to meet a higher capital requirement by decreasing their risk weighted assets rather than issuing new equity. This effect is well documented in practice. *See, e.g.*, Kristle Cortés et al., *Stress Tests and Small Business Lending* (NBER, Working Paper No. 24365, 2018), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3134262 (arguing that there is a theoretical result which suggests that the cost of debt should fall as banks become less leveraged, and hence that higher bank capital comes at little or no cost, known as the Modigliani Miller "theorem," but the derivation of this "theorem" assumes that there are no bankruptcy costs and no tax advantage for debt, so it is not applicable to real banks as well as being observationally falsified).

47. *See* Frederic Malherbe, *Optimal Capital Requirements over the Business and Financial Cycles* (Eur. Cent. Bank Working Paper Series, Paper No. 1830, 2015) (presenting a plausible macro-economic model in which this is true).

48. Posner, *supra* note 45 (describing this phenomenon as "norming" and describing how the fact that Basel 1 did not bind most banks was used as an excuse for not conducting an impact analysis).

49. Patricia Jackson et al., *Capital Requirement and Bank Behaviour: The Impact of the Basle Accord* (Basle Comm. on Banking Supervision Working Papers, Paper No. 1, 1999), https://www.bis.org/publ/bcbs_wp1.pdf.

50. DAGHER ET AL., *supra* note 23, at 6.

51. In a typical investment grade loan securitization of the period, the senior AAA-rated tranche would be roughly the top eighty percent of the structure. Therefore, it was possible to securitize a loan book, tranche the risk, retain the bottom twenty percent of the structure, sell the senior tranche and thereby reduce the total notional by a factor of five. *See* David Jones, *Emerging Problems with the Basel Capital Accord: Regulatory Capital Arbitrage and Related Issues*, 24 J. BANKING & FIN. 35, 43-44 (2000).

52. BCBS, INTERNATIONAL CONVERGENCE OF CAPITAL MEASUREMENT AND CAPITAL STANDARDS: A REVISED FRAMEWORK (2004), https://www.bis.org/publ/bcbs107.pdf [hereinafter BASEL 2].

capital requirements for credit risk, the internal ratings-based approaches.[53] Banks could use these approaches if they met specified standards of risk measurement and management.[54] Further, the second Accord modified the treatment of credit risk transfer and hedging arrangements, including securitization.[55] It also included new capital requirements for operational risk, provided guidance on the supervisory review of banks, and set minimum standards for bank public disclosures, thereby enhancing market discipline.[56]

For our purposes, two aspects of Basel 2 are pertinent. Its sheer size, complexity, and reach are notable. The first Accord is twenty-eight pages long and covers capital requirements for credit risk in the banking book only.[57] The second Accord is 239 pages and extends to the supervisory process and disclosure, as well as new prudential standards.[58] It bears emphasis that this ambition is unmatched by an increase in statutory authority: no country explicitly granted the BCBS permission to write such expansive and detailed rules—the Committee simply chose to do so.

The other aspect of note is that Basel 2 introduced meaningful choices into the calculation of capital requirements.[59] For credit risk, for instance, banks could apply to their supervisors for permission to use one of the two internal ratings-based approaches,[60] or they could remain on the default 'standardized' approach based on Basel 1. Similarly, banks meeting the requisite standards of risk management were permitted to calculate the operational risk capital charge using an 'advanced measurement approach.'[61] Basel 2, therefore, replaced a single required amount of capital for an asset under Basel 1 with a wide range of potential requirements depending on a bank's ability to use internal models for capital purposes and its implementation of those models.

The largest banks quickly embraced the potential of these modelling approaches due to the reduction in capital requirements available under

53. *Id.* at 60.

54. *Id.* at 142.

55. *Id.* at 118.

56. *Id.* at 175.

57. A "market risk amendment" was subsequently introduced. *See* BCBS, AMENDMENT TO THE CAPITAL ACCORD TO INCORPORATE MARKET RISKS (1996), https://www.bis.org/publ/bcbs24.pdf.

58. BASEL 2, *supra* note 52.

59. As Jeffery Atik puts it, Basel 2 thus replaces a single mandated capital requirement expressed as a percentage of the value of an asset under Basel 1 with "a range of permitted methodologies" likely giving a range of different requirements. Jeffery Atik, *Basel II: A Post-Crisis Post Mortem*, 19 TRANSNAT'L L. & CONTEMP. PROBS. 731, 732 (2011).

60. Some jurisdictions, including the United States, chose to require the banks subject to Basel 2 to meet the standards to use the advanced internal ratings-based approach. For a discussion of these standards, see RICHARD SCOTT CARNELL ET AL., THE LAW OF BANKING AND FINANCIAL INSTITUTIONS 3 (5th ed. 2013).

61. BCBS, INTERNATIONAL CONVERGENCE OF CAPITAL MEASUREMENT AND CAPITAL STANDARDS 143, 145 (2005), https://www.bis.org/publ/bcbs118.pdf.

them[62]—a reduction that sometimes proved imprudent when the financial crisis manifested in 2008. Moreover, the use of modelling approaches reduced the comparability of capital ratios[63] and increased the tendency of capital requirements to increase in times of economic stress.[64]

6. *The Rule-Making Process at the BCBS*

The Basel Committee comprises forty-five members from twenty-eight jurisdictions. Members are central banks and authorities with formal responsibility for the supervision of banking business.[65] Thus, all three of the U.S. prudential rule writers—the Federal Reserve Board, the OCC, and the FDIC—are members, as is the Federal Reserve Bank of New York (alone among the Federal Reserve Banks).[66]

The method for constructing BCBS standards is highly discretionary. There are no guidelines on the process nor, it seems, a body which is empowered to review whether a given rule-making has been conducted properly. Rather, the procedural methodology most commonly followed by the Committee is endogenous to its culture—and, thus, it is highly shaped by the political-economy realties and incentives of each of its member participants. That procedure generally tracks as follows.[67]

62. The availability in Basel 2 of lower capital requirements for banks which could meet high standards of risk management was controversial in the United States. Smaller and medium sized banks were concerned about the advantage that it could give to their larger peers, and hence lobbied to delay the implementation of Basel 2. *See* Lucia Quaglia, *The Politics of State Compliance with International "Soft Law" in Finance*, 32 GOVERNANCE 45, 51 (2019).

63. *See* Daniel Tarullo, Bd. of Governors of the Fed. Rsrv.. Sys., Rethinking the Aims of Prudential Regulation*,* Remarks at the Federal Reserve Bank of Chicago Bank Structure Conference (May 8, 2014) (transcript available at https://www.federalreserve.gov/newsevents/speech/tarullo 20140508a.pdf) (arguing, with regard to capital regulation under Basel 2, that "[t]he combined complexity and opacity of risk weights generated by each banking organization for purposes of its regulatory capital requirement create manifold risks of gaming, mistake, and monitoring difficulty. The IRB approach contributes little to market understanding of large banks' balance sheets, and thus fails to strengthen market discipline"); *see also* Atik, *supra* note 59.

64. Capital requirements are often "procyclical" in that they tend to increase in an economic downturn as they are based on risk estimates, and these estimates typically rise. Basel 2's credit risk requirements have come under significant criticism for this. For instance, Henrik Andersen finds that, using one approach to calculating capital under the Basel 2 internal models approach, "the added cyclical pressure on bank capital positions [compared to Basel 1] caused by Basel 2 is quite extreme," while using the other permitted method "the added cyclicality in the capital adequacy ratio is still sizeable." Henrik Andersen, *Procyclical Implications of Basel II: Can the Cyclicality of Capital Requirements Be Contained?*, 7 J. FIN. STABILITY 138 (2011); Panayiotis P. Athanasoglou et al., *Bank Procyclicality and Output: Issues and Policies*, 72 J. ECON. & BUS. 58 (2014).

65. *Basel Committee Overview*, *supra* note 27.

66. *Basel Committee Membership*, BANK FOR INT'L SETTLEMENTS (May 14, 2024), https://www.bis.org/bcbs/membership.htm.

67. Given the opaque nature of the BCBS, even the broad details of this procedure are not set out publicly. Rather, this information has been gleaned from discussions with participants in BCBS discussions.

The BCBS first sets forward a policy agenda. Absent a crisis, members jockey for power over its contents. Under stress, much or all the agenda may be imposed externally by politicians.

Once agreement is reached to create policy, a working group is formed. BCBS members again compete for influence, volunteering staff where they want power to shape the narrative, and stepping back when an issue is not deemed to merit a commitment of resources.

Subsequently, the working group gathers evidence. The group may conduct hearings or invite written submissions, but there is no requirement to do so. Where there are hearings, they are typically by invitation rather than open to the public.

One or more quantitative impact studies may be conducted, and a consultation paper will probably be issued.[68] It should be noted that these impact studies are often beset by bad data quality: the working group is reliant on individual members to approach their banks for data, and on the banks approached to provide it. Data are typically channeled through the relevant supervisor and anonymized before being shared with the wider group. This can mean that the data is not comparable, perhaps because the bank has misunderstood the requirement or because it cannot reliably calculate the impact of a proposed rule. Despite these issues, the calibration of the proposed rule is often based on these studies.

Then, the working group tries to find a consensus on a final rule. There are no formal standards for consideration of evidence or requirements for justification of policy proposals, so it is unclear how far the evidence gathered influences the process. A proposed rule does not have to be accompanied by an analysis of the various impacts of the proposed regulation, and most are not.[69] Working group members, and especially the chair, if they are so minded, can have a large influence on the text.

Once a proposal is finalized at the working level, it is passed up through a hierarchy of committees.[70] Members of higher-level committees typically have neither time nor resources to repeat the discussion conducted at the working group level, so decision-making is usually confined to the broad sweep of the proposed new rule, rather than its details.

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68. *See, e.g.*, Press Release, BCBS, The Basel Committee Consults on Revisions to the Pillar 3 Disclosure Framework (Feb. 27, 2018), https://www.bis.org/press/p180227.htm.

69. This was one of the main industry complaints about the Basel 3 Endgame discussed in Section C below. *See* Francisco Covas et al., *Basel III Endgame: Why a Comprehensive Quantitative Impact Analysis and Reproposal are Essential*, BANK POL'Y INST. (May 14, 2024), https://bpi.com/wp-content/uploads/2024/05/Basel-III-Endgame-Why-a-Comprehensive-Quantitative-Impact-Analysis-and-Reproposal-are-Essential.pdf.

70. *Policy Development and Implementation Review*, BANK FOR INT'L SETTLEMENTS (Apr. 14, 2018), https://www.bis.org/bcbs/review_process.

After the rule text has been agreed upon, the regulation is published. It is typically not accompanied by a substantive justification, nor an account of how it was calibrated, although there may be an impact analysis.

Importantly, there is no independent body to which stakeholders can appeal that has the authority to review transnational regulatory accords and to require that changes are made. Nor is there an independent body that is responsible for monitoring actual losses versus capital required across BCBS members. Finally, there is no independent body that is responsible for collating unintended consequences of BCBS rules and determining what changes are necessary.

7. *The Status of the Basel Committee and its Accords*

International organizations in Switzerland can be designated under the country's "host state act."[71] The BIS has been so designated,[72] and this grants it immunity from Swiss law "for all acts."[73] Thus, the BIS, and by inheritance the BCBS, are exempt from Swiss administrative law or freedom of information requirements, which would not have permitted the rule-making process described in the previous section, if they applied.[74]

Instead, the BCBS observes an opaque soft law process,[75] which operates by negotiation and consensus-formation among the participants in a Basel Committee working group, followed by Committee-based governance. As such, it is "dialogical, norm-generating, and incremental."[76] A balancing of working group members' interests, and then a further balancing of interests of the members of governance committees is necessarily required. Profound change is very difficult, absent a strong political mandate. Moreover, the form of a rule, once agreed in the working

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71. *Host State Act*, FED. DEP'T FOREIGN AFFS. (Switz.), (2024) https://www.eda.admin.ch/eda/en/home/foreign-policy/international-law/privileges-and-immunities/host-state-act.html.

72. The designation is available at Accord Entre le Conseil Fédéral Suisse et la Banque des Règlements Internationaux en vue de Déterminer le Statut Juridique de la Banque en Suisse [Agreement between the Swiss Federal Council and the Bank for International Settlements to Determine the Legal Status of the Bank in Switzerland], Switz.-Bank of Int'l Settlements, Feb. 10, 1987, https://www.fedlex.admin.ch/eli/cc/1987/471_471_471/fr and Liste des Organisations avec Lesquelles la Suisse a Conclu un Accord en Matiere des Privileges, Immunites et Facilites [List of the Organizations with Which Switzerland has Concluded an Agreement on Privileges, Immunities, and Facilities], Swiss Fed. Dep't of Foreign Affs. (July 15, 2024) https://www.eda.admin.ch/content/dam/eda/de/documents/aussenpolitik/voelkerrecht/DV-liste-abkommen-org_DE_FR_EN.pdf.

73. *See* Thore Neumann & Anne Peters, *Switzerland*, *in* THE PRIVILEGES AND IMMUNITIES OF INTERNATIONAL ORGANIZATIONS IN DOMESTIC COURTS 241, 244 (August Reinisch ed., 2013).

74. *Id.* at 242.

75. *See* Andrew T. Guzman & Timothy L. Meyer, *International Soft Law*, 2 J. LEGAL ANALYSIS 171 (2010). For more on soft law in general and for the Basel Accords as soft law, see Chris Brummer, *How International Financial Law Works (and How It Doesn't)*, 99 GEO. L.J. 257 (2011).

76. *See* Emily Lee, *The Soft Law Nature of Basel III and International Financial Regulations*, 29 J. INT'L BANKING L. & REGUL. 603, 603–12 (2015) (quoting Sungjoon Cho & Claire R. Kelly, *Promises and Perils of New Global Governance: A Case of The G20*, 12 CHI. J. INT'L L. 491, 497 (2012)).

group, is hard to modify, whatever its effects may later turn out to be, because it forms part of a complex package negotiated between members.

B. The Genus of Basel 3 and the First Basel 3 Rule-Set

1. Motivations for Basel 3: The 2008 Global Financial Crisis

The global financial crisis of 2007–09 was the most severe since the Great Depression of the 1930s. A decline in U.S. house prices crystalized losses from a significant amount of credit risk that had been building up on the balance sheets of large, hitherto reputable financial institutions due to their heavy exposure to residential-mortgage-linked products, notably securitizations.[77] When the losses on those assets materialized, they resulted in the failure (and, in some cases, government rescue) of several well-known financial institutions. A loss of confidence spread throughout the financial system, including to many nonbank financial institutions and markets, in what would come to be referred to as "contagion."[78] The cumulative effect of these events on the financial system spilled over into the real economy.

The resulting economic downturn led to public anger against banks, spurring political energy toward post-crisis bank policy reform. Generally, the focus of these reforms was on filling the gaps in regulation and supervision that seemed to have contributed to the crisis—and, in particular, to taking a system-wide, or "macroprudential," approach to financial regulation.[79] This stance called for higher prudential and supervisory requirements for the largest—and certainly the internationally active—banks.[80]

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77. *See generally* FIN. CRISIS INQUIRY COMM'N, THE FINANCIAL CRISIS INQUIRY REPORT (2011). The Financial Crisis Inquiry Commission concluded that the "financial crisis was avoidable" but had not been avoided due to a "pervasive permissiveness" among regulators with "little meaningful action was taken to quell the threats in a timely manner." *Id.* at xvii.

78. *See generally* Rosalind Z. Wiggins & Andrew Metrick, *The Lehman Brothers Bankruptcy H: The Global Contagion*, 1 J. FIN. CRISES (2019) (explaining the vectors of contagion and the affected parties). *See also* Eric Helleiner, *Understanding the 2007–2008 Global Financial Crisis: Lessons for Scholars of International Political Economy*, 14 ANN. REV. POL. SCI. 67 (2011), for a longer discussion of the crisis and the regulatory trends which helped to create the pre-conditions for it.

79. Piet Clement, *The Term "Macroprudential": Origins and Evolution*, 2010 BIS Q. REV. 59, 59–60; Nina Biljanovskam et al., *Macroprudential Policy Effects: Evidence and Open Questions* (IMF Departmental Paper Series, Paper No. 2023/02, 2023).

80. *See* John C. Coffee, Jr., *The Political Economy of Dodd-Frank: Why Financial Reform Tends to Be Frustrated and Systemic Risk Perpetuated*, 97 CORNELL L. REV. 1019, 1072–76 (2012).

2. *Immediate Post-Crisis Policy Making*

One of the results of this urge to reform was rapid agreement in the BCBS to develop a third Accord, Basel 3.[81] The initial version of this appeared in 2010 and reflected a profound change in regulatory mindset and methodology.[82]

Four key consensus views shaped the new Accord. First, that the crisis had, in significant measure, been the result of inattention to the build-up of risk and leverage in the financial system overall, and the remedy to this lapse would be multiple measures to increase capital (and liquidity).[83] There was a doubling-down on higher capital requirements as a way of preventing bank failure—or, at least, preventing contagion. For the internationally active banks, the quality of capital resources was increased, tier 1 equity capital requirements were increased to 4.5% of risk-weighted assets (6% for total tier one capital), and capital was required for additional risks.[84] A variety of surcharges and buffers were also added. This included a 2.5% capital conservation buffer and additional requirements for the very largest banks, the globally systemically important banks (G-SIBs), reflecting the additional risks they pose to financial stability: a 2.5% capital conservation buffer and the G-SIB surcharge that would range from 1.5% to 3.5% of risk-weighted assets.[85]

Second, there was a new emphasis on designing regulation to focus on systemic risk.[86] Thus, the package of reforms contained in Basel 3 took a macroprudential approach. It mandated tools for macroprudential

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81. *See* INITIAL BASEL 3 PACKAGE, *supra* note 5. For overviews on the Basel 3 regime, see Adrian Blundell-Wignall & Paul Atkinson, *Thinking Beyond Basel III: Necessary Solutions for Capital and Liquidity*, 2010 OECD J. FIN. MKT. TRENDS 9; Peter King & Heath Tarbert, *Basel III: An Overview*, BANKING & FIN. SERVS. POL'Y REP., May 2011, at 1; Christian M. McNamara, Michael Wedow & Andrew Metrick, *Basel III B: Basel III Overview*, 1 J. FIN. CRISES 59 (2019).

82. *See* Skinner, *supra* note 31, at 4 (discussing this shift to a macroprudential mindset).

83. The causes of the global financial crisis are multi-determined. For a general account, see FIN. CRISIS INQUIRY COMM'N, *supra* note 77.

84. *See* INITIAL BASEL 3 PACKAGE, *supra* note 5, at 12. Some of these new capital requirements overlapped with existing ones, creating risk "double counts." *See* MURPHY, *supra* note 12, for a discussion of this in the context of capital requirements for credit valuation adjustment risk.

85. Large banks would also be subject to a "total loss absorbing capital" (TLAC) requirement—a combination of capital and bail-in-able debt equal to 16% of risk-weighted assets (increasing to 18% by January 1, 2022). The TLAC requirement would complement separate efforts to establish resolution regimes, where banks would demonstrate sufficient equity and debt that could be converted by regulators to equity upon a pre-defined trigger to avoid an insolvency that could require a government bailout. FINANCIAL STABILITY BOARD, TOTAL LOSS-ABSORBING CAPACITY (TLAC) PRINCIPLES AND TERM SHEET (2015), https://www.fsb.org/2015/11/total-loss-absorbing-capacity-tlac-principles-and-term-sheet/.

86. *See* Stefan Walter, Sec'y Gen., BCBS, Remarks to the European Parliament Committee on Economic and Monetary Affairs on the BCBS' Reform Programme (May 3, 2010), (transcript available at https://www.bis.org/speeches/sp100503.htm); Nout Wellink, Chairman, BCBS, Remarks at the Institute of International Finance 2010 Spring Meeting: The Basel Committee and Regulatory Reform (June 11, 2010), (transcript available at https://www.bis.org/speeches/sp100611.pdf).

authorities (often central banks) to use to "lean against the wind," that is, cool down overheating credit markets.[87] A prominent example is the countercyclical capital buffer—central banks could dial up capital across the board by as much as 2.5% if they wanted to pump the brakes on credit growth.[88]

Third, a belt-and-suspenders paradigm was adopted. This focused on the use of precautionary measures rather than a cost-benefit (or marginal cost) approach to financial regulation.[89] Modelling approaches, which reduced the comparability of capital ratios, were de-emphasized, and various 'guard rails' to floor capital requirements were introduced.[90] These included the leverage ratio, a constraint on the total size of a bank's balance sheet given its capital (with both defined by regulators).[91]

Finally, Basel 3 took aim at bank funding and liquidity. A new liquidity ratio would require that a certain proportion of assets are highly liquid—these assets ("high quality liquid assets" or HQLA) would need to exceed the anticipated total net liquidity outflows over thirty days in a high-stress scenario.[92] Complementing this was a net stable funding ratio, placing constraining limits on banks' use of short-term funding.[93] This was meant to prevent banks from relying on what the BCBS had determined to be unstable (albeit less expensive) forms of funding—i.e., commercial paper, trading liabilities, federal funds borrowing, repos, and unstable deposits.[94]

The U.S. prudential regulators, for their part, implemented the bulk of the initial Basel 3 standards by 2013.[95] These rules were authorized by post-crisis legislation, namely the Dodd-Frank Act of 2010.[96] Coinciding with Basel 3, the Dodd-Frank Act required heightened prudential standards for the largest systemically important banks. As one of us has elsewhere pointed out, although U.S. bank regulators described the rule as implementing Basel

87. *See* Thore Kockerols & Christoffer Kok, *Leaning Against the Wind: Macroprudential Policy and the Financial Cycle* (Eur. Cent. Bank Working Paper Series, Paper No. 2223, 2019).

88. *See* INITIAL BASEL 3 PACKAGE, *supra* note 5, at 58. The intent was that these buffers could be released to counteract the procyclical increase in capital requirements in stress.

89. *See* Skinner, *supra* note 31, at 6.

90. *See* INITIAL BASEL 3 PACKAGE, *supra* note 5, at 60–61.

91. *Id.* at 60–61.

92. BASEL FRAMEWORK, LCR, *supra* note 38.

93. BCBS, BASEL III: THE NET STABLE FUNDING RATIO (2014), https://www.bis.org/bcbs/publ/d295.pdf.

94. *See* INITIAL BASEL 3 PACKAGE, *supra* note 5, at 9.

95. Press Release, Bd. of Governors of the Fed. Rsrv. Sys., Federal Reserve Board Approves Final Rule to Help Ensure Banks Maintain Strong Capital Positions (July 2, 2013), https://www.federalreserve.gov/newsevents/pressreleases/bcreg20130702a.htm [hereinafter Fed. Bd. Press Release].

96. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) (codified as amended in scattered sections of 12, 15, 18, and 42 U.S.C.).

3,[97] "the actual authority to develop those standards into U.S. law was grounded in [the] Dodd-Frank" Act as well as the International Lending Supervision (ILS) Act, which generally gives bank regulators the discretion to implement capital rules.[98] This statutory foundation was key to the legitimacy of prudential regulators' actions implementing the initial Basel 3 reforms into U.S. law.

C. The Basel 3 Endgame in the United States

In the decade after the implementation of the 2010 Basel 3 standards, large banks in the United States grew much stronger and more stable—and thus reduced their systemic risk. Tellingly, U.S. banks weathered the next major economic shock relatively well, during the 2020 COVID-19 pandemic and accompanying lockdowns. Indeed, the then-Fed Vice Chair for Supervision, Michael Barr, had noted in his 2022 confirmation hearing that "capital and liquidity in the system is very strong. The rules that Congress put in place after the financial crisis make it much less likely that such a financial firm could get itself into trouble and in a way that would cause problems for the broader economy."[99] At year end of 2022, all the U.S. G-SIBs were well above the minimum capital adequacy requirements in the initial Basel 3 package.[100]

However, the BCBS came back for more: rule-writing in Basel did not end in 2010. Indeed, the Committee proposed a large new package of rules in 2017, citing as support for this initiative the fact that unnamed "academics, analysts and market participants [had] lost faith in banks' reported risk-weighted capital ratios" during the crisis.[101] The 'Basel 3 endgame' rules were purportedly designed to address these concerns.[102]

The U.S. authorities followed suit. In July 2023, the Fed, OCC, and FDIC jointly proposed a rule that purported to implement the Basel 3

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97. Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Capital Adequacy, Transition Provisions, Prompt Corrective Action, Standardized Approach for Risk-weighted Assets, Market Discipline and Disclosure Requirements, Advanced Approaches Risk-Based Capital Rule, and Market Risk Capital Rule, 78 Fed. Reg. 62018 (proposed Oct. 11, 2013) (to be codified at 12 C.F.R. pts. 3, 5, 6, 165, 167).

98. Skinner, *supra* note 31, at 29–30; 12 U.S.C. § 3907 (2010).

99. *Nominations of Michael S. Barr, Jaime E. Lizarraga & Mark Toshiro Uyeda: Hearing Before the Comm on Banking, Hous., & Urb. Affs.*, 117th Cong. 2 (2022) (statement of Sen. Patrick J. Toomey).

100. Peter Ryan & Guowei Zhang, *How the Basel III "Endgame" Reforms Will Transform US Capital Requirements*, SIFMA (Feb. 27, 2023), https://www.sifma.org/resources/news/how-the-basel-iii-endgame-reforms-will-transform-us-capital-requirements/.

101. BCBS, BASEL III: FINALISING POST-CRISIS REFORMS 1 (2017), https://www.bis.org/bcbs/publ/d424.pdf [hereinafter BASEL 3 ENDGAME].

102. As the bank regulators have described it, the proposed rule aims to implement "enhanced regulatory capital requirements that align with the Basel Endgame package issued by the Basel Committee on Banking Supervision." *See* Press Release, Bd. of Governors of the Fed. Rsrv. Sys., Agencies Reaffirm Commitment to Basel III Standards (Sept. 9, 2022), https://www.federalreserve.gov/newsevents/pressreleases/bcreg20220909a.htm.

endgame.[103] This U.S. endgame proposal significantly increased capital requirements for all four categories of large U.S. banks.[104] All banks with over $100 billion in assets were expected to transition to an "Expanded Risk-Based Approach," a methodology designed to account for more possible sources of credit risk among various types of credit exposure.[105]

Per the initial proposal, banks would also have had to adopt new methods for calculating market and (as discussed further below) operational risk. Among other changes, the new market risk method required banks to stress their trading book for potential losses arising from market shocks and volatility. This new method, known as the Fundamental Review of the Trading Book (FRTB), would have dramatically increased capital requirements for market risk.[106] Capital requirement add-ons to account for operational risk would have also been standardized, introducing a new capital component for regional banks.[107]

The initially proposed endgame rule also changed the inputs to the capital adequacy ratio. It further revised what qualified as eligible capital in the numerator of the capital ratio.[108] Among other things, the changes would have made regulatory capital levels more sensitive to unrealized losses for certain categories of banks.[109] Finally, the rule proposed adjustments to the calculation of how assets are weighted according to their risk by adjusting the risk weights that apply to certain asset categories.[110] Inherently, altering these risk weights reflects a value judgment about certain types of

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103. It bears emphasis that this brief summary only highlights some of the key aspects of the rule, which is over 1,000 pages long.

104. Notably, the Basel Committee had expressed desire for the endgame to be "capital neutral"; that is, while it would change methodologies for capital calculations, it would not increase the amount of capital required. BASEL 3 ENDGAME, *supra* note 101, at 1. The U.S. rule is not capital neutral as currently proposed.

105. *See* Memorandum from Staff of Bd. of Governors of the Fed. Rsrv. Sys. to Bd. of Governors of the Fed. Rsrv. Sys. (July 18, 2023), https://www.federalreserve.gov/aboutthefed/boardmeetings/gsib-memo-20230727.pdf.

106. *See* Luigi De Ghenghi et al., *U.S. Basel III Endgame Proposed Rule*, DAVIS POLK & WARDWELL, at 146–47 (Sept. 14, 2023), https://www.davispolk.com/sites/default/files/2023-09/us-basel-iii-endgame-proposed-rule.pdf (estimating that the Proposed Rule would increase risk-weighted assets associated with trading activity by sixty-seven percent for Category I through IV banking organizations).

107. *See id.* at 135.

108. *See* INITIAL BASEL 3 PACKAGE, *supra* note 5, at 12.

109. *See* the U.S. Endgame Proposal, *supra* note 6, at 64031 ("Category III or IV banks would be subject to the same treatment of accumulated other comprehensive income (AOCI), capital deductions, and rules for minority interest as banking organizations subject to Category I or II capital standards.").

110. The FDIC has estimated that the proposal will increase risk-weighted assets by twenty percent in aggregate across affected banking organizations at the holding company level. *See* Memorandum from Doreen R. Eberley, Dir., Div. of Risk Mgmt. Supervision of Fed. Deposit Ins. Corp., to Bd. of Dirs. of Fed. Deposit Ins. Corp. 19 (July 27, 2023), https://www.fdic.gov/news/board-matters/2023/board-meeting-072723-open.html; *see also* Michael Barr, Vice Chair, Bd. of Governors of the Fed. Rsrv. Sys., Remarks Before the Bipartisan Policy Center: Holistic Capital Review (July 10, 2023), https://www.federalreserve.gov/newsevents/speech/barr20230710a.htm.

bank investments, inevitably skewing a bank's behavior—a higher risk weight disincentivizes investment in that asset.

In a separate rule, the Fed proposed changing the methodology for calculating the capital surcharge that applies to the G-SIBs.[111] The surcharge also followed from a Basel 3 standard. In its rationale for the rule, the Fed explained that "[t]he proposed changes include revisions consistent with the framework used by [the BCBS] to identify GSIBs and assess their systemic importance."[112] Like the endgame proposal, the G-SIB surcharge focused on reducing variability among banks and, in this case, across jurisdictions. As the regulators stated: "Additionally, many of the amendments would improve measurement and reporting consistency across jurisdictions, by aligning with changes to the international GSIB surcharge standard published by the Basel Committee on Banking Supervision."[113]

Implementing these rules would certainly have introduced social and economic costs. Increased capital requirements invariably hamper banks' ability and appetite to lend and thus drive up the cost of bank-supplied credit. The knock-on effects are likely to include: the rise of incentives for bank consolidation in ways that might erode the three-tier model that currently exists; shifts of credit intermediation to areas outside the banking sector; and, more broadly, the amplification of regulatory discretion within these internationally active banks by forcing greater standardization among risk assessment models with standards set by unelected regulators, not the private market.

As such, basic norms of public law seem to require a compelling rationale for these rules. However, as will be discussed in Part III, the factual basis for this suite of Basel-endgame and endgame-adjacent rules was lacking at the time of their proposal.

III. LEGAL AND LEGITIMACY PROBLEMS WITH THE BASEL PROCESS

This Part turns to the legitimacy and rule-of-law problems that have accumulated in connection with Basel's work over the past fifteen years. These problems center on the BCBS' lack of transparency and democratic accountability at the global level, and the U.S. banking agencies' willingness

111. Regulatory Capital Rule: Risk-Based Capital Surcharges for Global Systemically Important Bank Holding Companies; Systemic Risk Report (FR Y–15), 88 Fed. Reg. 60385 (proposed Sept. 1, 2023) (to be codified at 12 C.F.R. pt. 217).

112. *Id.* at 60386.

113. *Id.* at 60397. Notably a third rule would require large banks to have high minimum amounts of long-term debt—ostensibly to improve their resolvability and resiliency. *See* Press Release, Bd. of Governors of the Fed. Rsrv. Sys. et al., Agencies Request Comment on Proposed Rule to Require Large Banks to Maintain Long-Term Debt to Improve Financial Stability and Resolution (Aug. 29, 2023), https://www.federalreserve.gov/newsevents/pressreleases/bcreg20230829a.htm. This rule would not affect the G-SIBs, only the banks with $100 billion or more in assets, which we commonly think of as the regional banks.

to short-circuit U.S.-specific administrative law requirements to justify their implementation.

A. Global Administrative Law

The term "global administrative law" is used for the rules, principles, norms, and processes of administration that stretch beyond national borders.[114] Examples of this kind of bureaucratic technology have multiplied in recent years and arise in diverse fields, including measurement standards, health, climate change, and financial regulation.

No assumption is made that a given transnational bureaucratic technology is law.[115] Rather, global administrative law studies areas which make law-like claims,[116] use legal reasoning, and have law-like enforcement mechanisms without arising from the authority and norm-defining power of the state.[117] Thus, global administrative law considers the Basel Accords, while their implementation in a federal agency regulation is a matter of U.S. administrative law.

1. Global Administrative Law Norms

The kinds of bureaucratic technology studied by global administrative law have regularly been confronted by demands for more transparency, stakeholder consultation, evidence of reasoned decision-making, and review. On this basis, a body of scholarship has developed which articulates legitimating principles for global administrative law-like edicts.[118] They are

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114. *See* Sabino Cassese, *Global Administrative Law: The State of the Art*, 13 INT'L J. CONST. L. 465 (2015), for a further discussion of the nature and definition of global administrative law. Alexander Somek, *The Concept of 'Law' in Global Administrative Law: A Reply to Benedict Kingsbury*, 20 EUR. J. INT'L L. 985, 986 (2009), emphasizes that in this area "[t]here is neither system nor centre, but merely a number of family resemblances among different processes," so scholarship in this area should be sensitive to these differences.

115. Indeed, whether they are is contested. *See* Benedict Kingsbury, *The Concept of 'Law' in Global Administrative Law*, 20 EUR. J. INT'L L. 23 (2009) and Somek, *supra* note 114, for some of the arguments.

116. Kingsbury, *supra* note 115, at 31 (identifying as a key property whether the policy "has been wrought by the whole society . . . [and it] addresses matters of concern to the society").

117. *See supra* note 114.

118. Julia Black, *Constructing and Contesting Legitimacy and Accountability in Polycentric Regulatory Regimes*, 2 REGUL. & GOVERNANCE 137 (2008), argues that "legitimacy is rooted in the acceptance" of an organization by others but, as Somek, *supra* note 114, at 993, points out, that hinges on the regulated having a genuine choice not to accept, given the disciplinary mechanisms in place. Moreover, acceptance can be nuanced: a stakeholder might, for instance, accept the legitimacy of a state or bloc-level regulator without recognizing the legitimacy of a transnational body of which that regulator is a member.

commonly understood to represent "values that are immanent within the modern practice of public law."[119] These, in summary, are:[120]

Legality and accountability under the law.[121] This is the principle that authority has been delegated under domestic law to a bureaucratic agent, that the agent's authority is constrained by that delegation, and that the law will hold them accountable for their actions. Specifically, it suggests that an independent review process should be in place to implement this accountability.[122]

Participation from affected stakeholders.[123] A focus on the public good, with potential participation by all of society, is "a necessary element in the concept of law under modern democratic conditions."[124] If transnational regulation is to be legitimate, it must inform all stakeholders of proposed changes, give them all an opportunity to comment, and act on the comments received.

Transparency and predictability of process.[125] This principle requires that there is an agreed-upon and publicized process for making rules: stakeholders should know what is being done, by whom, based on what evidence, for what reasons, and on what timescale.

Rationality of decision-making based on evidence presented.[126] The idea here is that decisions should not be arbitrary or capricious and should be rooted in an analysis of conscientiously-gathered evidence.

Proportionality and protection of rights.[127] This principle requires that an interference with rights must be justified, and that interference must be proportional to the importance of the authorities' goals.

Independent dispute resolution mechanisms.[128] The existence of an independent dispute-adjudication mechanism, such as a court or an independent ombudsman,[129] provides some protection for stakeholders that the rules made are interpreted reasonably and coherently.

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119. The phrase is from Gus Van Harten & Martin Loughlin, *Investment Treaty Arbitration as a Species of Global Administrative Law*, 17 EUR. J. INT'L L. 121, 150 (2006).

120. *See* Carol Harlow, *Global Administrative Law: The Quest for Principles and Values*, 17 EUR. J. INT'L L. 187 (2006).

121. *Id.* at 192.

122. *See* Andres Gonzalez-Watty, The Quest for Accountability in Transnational Regulatory Networks: The Case of the Basel Committee on Banking Supervision (2016) (Ph.D. thesis, University of Oxford) (on file with the Virginia Journal of International Law Association), for a further discussion of the accountability of financial regulators.

123. Harlow, *supra* note 120, at 193.

124. Kingsbury, *supra* note 115, at 31 calls this "publicness."

125. Harlow, *supra* note 120, at 199.

126. *Id.* at 194.

127. *See id.* at 195; Kai Möller, *Proportionality: Challenging the Critics*, 10 INT'L J. CONST. L. 709, 711 (2012).

128. Harlow, *supra* note 120, at 208.

129. *See* Verdier *supra* note 17, at 1422 (alluding to the Dispute Settlement Panels of the World Trade Organization); MARY ELLEN O'CONNELL, INTERNATIONAL DISPUTE RESOLUTION: CASES AND MATERIALS 105–06 (2d ed. 2012) (discussing the various types of arbitration mechanisms).

Review mechanism. None of the other principles are effective unless there are mechanisms to challenge potential failures to observe them and to review the continuing appropriateness of the rules. This requires the existence of an independent body with the power to enforce change if standards of good administration and effectiveness are not met.[130]

Financial policymaking by transnational regulatory bodies, such as the Basel Committee, clearly falls under global administrative law. These acts have authority, the standard-setting bodies are public and international, and their actions are made based on a competence handed down to each of their constituent public authorities. But are they *legitimate* global administrative law, in the light of the norms we just described?[131]

2. *Legality and Accountability Under the Law*

Legality and accountability are typically straightforward for transnational financial regulation. The authorities involved have been delegated authority to make rules, and they are not prohibited from cooperating.[132] That being said, it is important to bear a key distinction in mind: although the regulators have delegated authority to make rules, they do not have direct legal authority to make a carbon copy of the Basel rules as U.S. law.

As is the case for the U.S. banking agencies, the ILS Act gives the agencies discretion to make capital rules, and it requires that they "consult with the banking supervisory authorities of other countries to reach understandings" on "effective and consistent supervisory policies and practices"[133] in regard to international lending—but neither the ILS Act nor any other statute binds the U.S. banking agencies to Basel's rules.

3. *Participation from Affected Stakeholders*

"Input legitimacy"[134] refers to the representation of all interested parties in administrative decision-making, if such a decision is to be regarded as

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130. Somek, *supra* note 114; Black, *supra* note 118, at 138.

131. Indeed, as Craig discusses, the growth of global administrative law was partly motivated by the need to provide norms through which to analyze what was becoming increasingly important global regulatory activity. *See* PAUL CRAIG, UK, EU AND GLOBAL ADMINISTRATIVE LAW: FOUNDATIONS AND CHALLENGES 647 (2015).

132. This is not settled. See, for example, Letter from Patrick McHenry, Vice Chairman of the Fin. Servs. Comm., to Janet Yellen, Chair, Bd. of Governors of the Fed. Rsrv. Sys. (Feb. 6, 2017), where the writer states that it "appears that the Federal Reserve continues negotiating international regulatory standards for financial institutions among global bureaucrats in foreign lands without transparency, accountability, *or the authority to do so*" (emphasis added).

133. 12 U.S.C. § 3901(b) (1983).

134. The term is from Erzsébet Csatlós, *Public Administrative Law in a Globalized Concept: Legal Nature of the Collaboration of the EU and the Basel Committee*, 22 J. INT'L ECON. L. 229, 231 (2019). In contrast, "output legitimacy" occurs when a system of governance produces results which are deemed by stakeholders to efficiently cater to the public interest.

legitimate. This implies not just consultation but also listening to and acting upon the replies. In a dialogue as imbued with power imbalance as that of financial regulators with the firms they regulate, regarding regulation, it is important to have a mechanism for leveling the playing field.

Defenders of the legitimacy of the transnational financial rule-making process argue that its rule-making includes significant participation from stakeholders and that, over time, improvements in transparency have "permitted a wider range of actors to comment."[135] The suggestion is that standard setters' work "appears to have been responsive to suggestions made during the notice and comment process."[136] This may be a reasonable characterization of the rule-making process for Basel 2, but there is less evidence of input legitimacy in the regulatory counter-reformation that produced Basel 3.[137]

4. *Transparency and Predictability of Process*

The origins of much transnational regulation are opaque. There is no public agenda of precise topics under consideration.[138] Often, stakeholders outside the Basel club only learn of the Committee's intention to make new rules when a consultation paper is issued. At that point, it is very difficult to make more than minor alterations to the direction of travel. Thus, there is a process by which transnational regulation is made, but, for many stakeholders, it is only predictable once new rules have become almost inevitable.

There are further transparency issues with transnational financial regulation. First, the details of who is responsible for a rule are not disclosed. Stakeholders do not know working group membership, the membership of the higher-level committees such as the Policy and Standards Group, except for Group Chairs, nor who was consulted during policy development. Minutes of meetings are not typically published. Finally, and problematically for the proponents of the claim that "consultation builds legitimacy," there

135. *See* Michael S. Barr & Geoffrey P. Miller, *Global Administrative Law: The View from Basel*, 17 EUR. J. INT'L L. 15, 26 (2006).

136. *Id.*

137. *Id.* at 25–27, cites as an example of the Committee's attention to stakeholder comment during Basel 2 that the Committee "yielded somewhat on capital charges for operational risk." Perhaps it did, but that concession disappeared in the final version of Basel 3. *Compare* BASEL 2, *supra* note 52, ¶¶ 655–659, *with* BASEL 3 ENDGAME, *supra* note 101, at 128.

138. The *Basel Committee Work Programme and Strategic Priorities for 2025/26*, BANK FOR INT'L SETTLEMENTS, https://www.bis.org/bcbs/bcbs_work.htm?m=80 (last visited May 23, 2024), simply contain generalities such as work on the "digitalisation of finance."

is no disclosure of which comments the Committee accepted, which it rejected, and why.[139]

5. Rationality of Decision-Making Based on Evidence Presented

A legitimating account of decision-making in bank rule-making would start by presenting the evidence to support the desirability of a particular regulatory goal, a proposed mechanism to achieve that goal, and an analysis of the effectiveness of that mechanism compared to other choices. The account of decision-making would then present a potential rule and show how each part of it was determined. The net effect of each element would be examined for a range of different portfolios or banks. This would demonstrate that the rule choice was indeed a rational outcome of an evidence-based approach.[140]

The BCBS makes no attempt to evidence rationality in this way. This is in part because Basel Accords are negotiated and hence reflect compromises. A very clear example can be found in the Basel 3 endgame output floor. This is a kind of guardrail, as discussed previously.[141] It requires that, where banks have permission to use internal models for the calculation of capital requirements, the risk-weighted asset requirements for modelled portfolios cannot, in aggregate, fall below 72.5% of the risk-weighted assets computed by the standardized approaches.[142] It is therefore a floor on the benefit available from modelling. Two questions immediately arise here: why is this necessary, and if it is necessary, where does 72.5% come from?

The necessity of this measure in the United States is particularly unclear given that there is already a measure that achieves the same effect, and which has the benefit of legitimacy: the Collins Amendment.[143] This measure is

139. Barr & Miller, *supra* note 135, at 24, tellingly say "the Committee issued background papers to inform the public about its thinking on key issues," and not, as the reader will notice, to stimulate a debate, nor to gather evidence. We are granted insight into what is going to be done, not being asked whether it should be done, or what might be better.

140. Benedict Kingsbury et al., *The Emergence of Global Administrative Law*, 68 LAW & CONTEMP. PROBS. 15, 38 (2005). The authors state that "the Basle [sic.] Committee and [the International Organization of Securities Commissions] have developed web sites that contain abundant material on internal decisionmaking and the information and considerations on which decisions are based" but give no evidence of this. Indeed, it would be an interesting challenge for the reader to select a rule in Basel 3 and try to find the "material on internal decision making" supporting the precise rule text, including the calibration chosen.

141. *See supra* Section II.B.2.

142. MARC LABONTE & ANDREW P. SCOTT, CONG. RSCH. SERV., R47855, BANK CAPITAL REQUIREMENTS: BASEL III ENDGAME 8 (2023).

143. The Collins Amendment, named after U.S. Senator Susan Collins, is in Section 171 of the Dodd-Frank Act and is codified in 12 U.S.C. § 5371. This floors capital requirements at "the generally applicable risk-based capital requirements that were in effect for insured depository institutions as of July 21, 2010," in other words, at the level established by the standardized approach as of that date. *See* 12 U.S.C. § 5371(b)(2).

targeted at exactly the same issue as the output floor and has been settled law for roughly fifteen years.[144] Another, differently phrased requirement seems to offer little additional benefit while generating significant implementation cost.[145]

The calibration of the output floor is the result, not of careful analysis of costs versus benefits, but of negotiation. Broadly, European regulators and politicians preferred a lower output floor,[146] while U.S. regulators—perhaps because they already had the Collins floor, and hence wanted to impose comparable costs on banks outside the United States—preferred a higher one.[147] The positions crystallized into a European proposal of 70% versus an American one of 75%; the final 72.5% simply reflects an agreement to split the difference.[148]

6. *Proportionality Analysis of Bank Prudential Regulation*

The concept of proportionality is a longstanding one in administrative law. Its origin lies in Prussian court review of police actions that infringed the rights of individuals.[149] It has become a key feature of EU administrative law,[150] and is now "the most important doctrinal tool in constitutional rights law."[151]

The form of the argument justifying the proportionality of a policy is, in sketch, fourfold. There must be a stated, legitimate goal that the policy is pursuing. There must be a rational connection between the policy and the achievement of the goal. There should be no less intrusive but equally

144. *Id.*

145. For a detailed discussion of how the U.S. Basel 3 endgame proposals render the Collins floor superfluous, see Guowei Zhang et al., *Understanding the Proposed Changes to the US Capital Framework*, SIFMA (Aug. 28, 2023), https://www.sifma.org/resources/news/blog/understanding-the-proposed-changes-to-the-us-capital-framework/.

146. *See, e.g.*, Mark Daley, *The European Parliament Offers the Prospect of Relief Regarding the Upcoming Output Floor*, DLA PIPER (Jan. 27, 2023), https://www.dlapiperintelligence.com/investmentrules/blog/articles/2023/eu-securitisation-update.html (discussing the European Parliament offering relief from certain output floor provisions).

147. Some sense of these negotiations can be found in William Coen's keynote address at the International Financial Services Forum. William Coen, BCBS Sec'y Gen., Speech at the International Financial Services Forum: Regulatory Equivalence and the Global Regulatory System (2017), https://www.bis.org/speeches/sp170525.pdf. Coen, who was at the time Secretary General of the BCBS, states that in 2017, the calibration of the output floor is an "piece of unfinished business" and that—reflecting conflicting EU and U.S. proposals—it could be set at "say, 70–75% of the risk-weighted assets."

148. *Id.*

149. *See* FRITZ FLEINER, INSTITUTIONEN DES DEUTSCHEN VERWALTUNGSRECHTS (1928). As Fleiner writes, "Die Polizei soll nicht mit Kanonen auf Spatzen schießen"—the police should not use cannons to shoot sparrows. *Id.* at 404.

150. *See* Consolidated Version of the Treaty on European Union art. 5(4), May 9, 2008, 2008 O.J. (C 115).

151. *See* Möller, *supra* note 127, at 709.

effective alternative policy. Finally, there must be a balance between the importance of rights affected by the policy and the importance of the goal.[152]

Much transnational financial regulation is on difficult ground here. The goals, to the extent that they are stated at all, are diffuse ones, like financial stability or the robustness of financial institutions. The rights interfered with are not only the property rights of the regulated, but also those of their clients and potential clients. The latter are typically not considered by bank rule makers. While there is often a general mechanism, such as the loss absorbency of capital, that supports the need for the proposed policy, the 'no better alternative' leg of the justification is typically missing. Moreover, there are sometimes countervailing mechanisms which mean that the goal is not met at all, especially after the financial system adapts to regulation.[153]

7. *Regulatory Calibration under the Lens of Proportionality*

Suppose that there is a public policy goal of making large banks 99.9% safe over one year. On average, we want only one bank in a thousand to fail each year.[154] To begin with, suppose that banks are only exposed to a single risk factor, *A*, say, coming from one business line. We would then calibrate capital requirements by estimating the one-year loss distribution from this risk factor and requiring banks to hold enough capital to absorb 99.9% of losses.[155] Now suppose that there is a second risk factor, *B*, say, arising from a second business line. We could proceed similarly for this risk, and add the two capital requirements, or we could measure the diversification between the two risks and estimate the joint risk distribution. Both approaches treat the two risks equally.

Suppose now that we instead only calculate losses for risk factor *B* at 99.8%. This would make the business line generating *B*-risk more attractive than the one generating *A*-risk. Banks would shift their activity, reducing the first business line and increasing the second. Thus, by calibrating capital requirements for different areas of bank activity, regulators shape the attractiveness of the various business lines banks conduct. Given this fact, one might expect regulators to be mindful of the incentives embedded in their rules.

But this is not the case. There is no overarching safety standard for capital requirements. The requirements for different risks target different

152. *See* MURPHY, *supra* note 12, at 240.

153. *Id.* at 109–11.

154. This is the safety standard that the Basel 2 internal ratings-based approach is calibrated to, although there are reasons to believe that it does not achieve this level of safety. *See* Sanjiv Das, *Basel II: Correlation Related Issues*, 32 J. FIN. SERVS. RES. 17 (2007).

155. Or, more properly, as we will argue later, we would set capital requirements so that banks remained sufficiently capitalized to attract new wholesale funding after such a loss.

standards.[156] Moreover, the calibration of BCBS rules relies on quantitative impact studies prior to rule making, which often suffer from poor data quality. There is no uniform process to review losses post-implementation and revise the calibration of regulatory standards. This incoherence creates a myriad of incentives for banks. Where the calibration of regulation is particularly penal, as for the FRTB, banks take very little risk.[157] Where they are more generous, as for high quality residential mortgage lending for banks using the advanced internal ratings-based approach under Basel 2,[158] banks take a larger role.

This discussion highlights the importance of a proportionality analysis that assesses not just whether the costs of extra capital in total are justified, given its benefits, but also whether capital requirements are correctly allocated between bank business lines. The inhomogeneous safety standards used in BCBS rule-making, combined with the lack of comprehensive loss analysis in post-implementation review, make it highly likely that such an analysis would not support the current calibration of much of the Basel 3 endgame proposal.[159]

8. *Independent Determination of Disputes*

Ordinarily, independent dispute resolution involves an external assessment of whether an organization has complied with a rule—in other words, this is a question of who interprets what it means to comply. Independence in this manner can also suggest the need for an external analysis of whether, when circumstances change, compliance with a given rule's letter is still consistent with its spirit.

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156. Compare the 97.5% expected shortfall standard in BCBS, *Fundamental Review of the Trading Book: A Revised Market Risk Framework* 19 (Oct. 2013), https://www.bis.org/publ/bcbs265.pdf, with the 99.9% standard in the internal ratings based approach in *Basel 2*, *supra* note 52, Annex 2, ¶ 16.

157. Thus, even systemically important markets, such as the repo market for U.S. government debt, now rely on (relatively fragile) liquidity provisions by highly-leveraged non-bank intermediaries, rather than on bank-based intermediation. For fragility, see Anne-Caroline Hüser et al., *How Does the Repo Market Behave Under Stress? Evidence from the COVID-19 Crisis*, 70 J. FIN. STABILITY 1, 1 (2024).

158. In the advanced internal ratings-based approach, banks are required to estimate the loss given default for loans. High-quality mortgages—those with a loan-to-value ratio of 80% or less—typically have rather low estimates of the loss given default, given the extent to which the value of the collateral exceeds the amount outstanding on the loan. This, combined with low estimates of the probability of default of such loans and the generous default correlation for residential mortgages used in Basel 2, generates low capital requirements. *See* Matteo Benetton et al., *Capital Requirements and Mortgage Pricing: Evidence from Basel II*, 48 J. FIN. INTERMEDIATION 1, 1 (2021) (finding that "[t]he implementation of the Basel II regime in the UK resulted in a large, coordinated fall in mortgage capital requirements across most lenders").

159. The problems identified in the endgame proposal calibration include the treatment of market risk and securities underwriting, dramatic increases in capital requirements for fee-based businesses such as credit card provision and asset management, and penal revisions to the capital requirements for tax-credit investments (which are important in financing the green transition). *See, e.g.*, Ryan & Zhang, *supra* note 100.

But in transnational financial regulation, dispute resolution is self-referential, not independent. This is to say that disputes about whether a given approach complies with transnational financial regulation are resolved by the rule-maker itself. Accordingly, the requirement for an independent dispute resolution mechanism is problematic for transnational banking regulation.[160]

9. *Review Mechanism*

The closest thing the Basel framework has to a review mechanism is the Financial Stability Board's Framework for Monitoring the Implementation of Agreed G20/FSB Financial Reforms, which does include review of some BCBS-made rules.[161] However, this is not an independent review of good administrative and effective rule-making. It takes as its starting point that "the success of the financial regulatory reform efforts . . . depends on the complete and globally consistent implementation" of the agreed policies.[162]

The material in this section so far suggests that, from a global administrative law perspective, the BCBS has a legitimacy problem. The methods adopted in regulatory cooperation in Basel often largely or completely bypass home state administrative law requirements. Moreover, these methods are unnecessary for their success—there is no need to maintain opacity, to refuse dialogue of equals with stakeholders, or to lack an independent dispute adjudication or other review mechanism. These features are convenient for the authorities involved, no doubt, but they do mean that the "guarantees that protect individuals against authority powers are under construction."[163]

B. *U.S. Administrative Law*

As previously discussed, the U.S. rule-making process requires that any Basel soft-law standard be promulgated as a rule before it becomes binding on those banks regulated by U.S. prudential regulators.[164] Accordingly, no aspect of the Basel Accords can technically function as U.S. law until it becomes a final rule by satisfying the requirements of notice and public

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160. The various Basel 3 "frequently asked questions" publications are an example of this adjudication of compliance with BCBS rules by the BCBS. *See, e.g.*, *Basel III Definition of Capital – Frequently Asked Questions*, BANK FOR INT'L SETTLEMENTS (Sept. 19, 2017), https://www.bis.org/bcbs/publ/d417.htm.

161. *See* FINANCIAL STABILITY BOARD, A COORDINATION FRAMEWORK FOR MONITORING THE IMPLEMENTATION OF AGREED G20/FSB FINANCIAL REFORMS (Oct. 18, 2011), https://www.fsb.org/work-of-the-fsb/implementation-monitoring/.

162. *Id.* at 4. Surely this premise is only true if the agreed policies are effective—something a genuine review would probe.

163. *See* Csatlós, *supra* note 134, at 245.

164. Basel Committee Charter, *supra* note 32.

comment under the Administrative Procedure Act (APA).[165] In short, this requires an agency to publish a proposed rule, solicit public comment on the proposal, consider the comments, and only then pass a final rule.

1. *The Arbitrary and Capricious Standard*

The motivation for the APA is to protect against *ultra vires* or arbitrary agency action.[166] Accordingly, the APA entitles any person adversely affected by an agency action (including, of course, a rule) to challenge that action in federal court.[167] In its review, the court applies what is generally referred to as the arbitrary and capricious standard, considering whether the agency action has been "arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with the law."[168]

There are a few basic indicators of agency action that passes the arbitrary and capricious standard. For one, there must be a "rational connection between the facts found and the choice made"—meaning, obviously, that there must be some robust fact-finding to support the agency action or decision.[169] But just as importantly, the fact-finding must be credible. An agency action should be found arbitrary or capricious if:

> [T]he agency has relied on factors which Congress has not intended it to consider, entirely failed to consider an important aspect of the problem, offered an explanation for its decision that runs counter to evidence before the agency, or is so implausible that it could not be ascribed to a difference in view or the product of agency expertise.[170]

Finally, although conducting cost-benefit analysis is not a formal legal requirement for independent agencies, some of the financial regulatory agencies do it as best practice. The SEC, for example, adopted the position that cost-benefit analysis was not necessary in areas where Congress had left the Commission no discretion in fashioning a rule, but in other cases, the Commission would present the public with the cost-benefit analysis of its rule.[171]

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165. 5 U.S.C. § 553.
166. *Id.* § 706.
167. *Id.* § 702.
168. *Id.* § 706. *See, e.g.*, Marsh v. Oregon Natural Res. Council, 490 U.S. 360, 378 (1989) (internal quotations omitted).
169. Bowen v. Am. Hosp. Ass'n, 476 U.S. 610, 626 (1986).
170. Motor Veh. Mfrs. Ass'n v. State Farm Mut. Auto. Ins. Co., 463 U.S. 29, 43 (1983).
171. In 2014, the D.C. Circuit effectively conceded in the conflict minerals case that where Congress mandates a rule that is not based on investor protection—and did not do cost-benefit analysis—the SEC may not be required to do cost-benefit analysis. *See* Nat'l Ass'n of Mfrs. v. SEC, 748 F.3d 359, 369 (D.C. Cir. 2014), and, for comment on the SEC's approach, John C. Coates, IV, *Cost-Benefit Analysis of Financial Regulation: Case Studies and Implications*, 124 YALE L.J. 882 (2015).

Inasmuch as agencies seldom lose in court against the arbitrary and capricious standard,[172] where the agency has been fast and loose with the facts and presented shoddy cost-benefit analysis—all while intending to impose significant burden on a regulated party—courts will act to strike down the action or the rule. The case of the Financial Stability Oversight Council's (FSOC) early use of its systematically important financial institution (SIFI) designation power is a case in point.[173] After the FSOC was established (as conceived by the Dodd-Frank Act), it quickly began its work of identifying nonbank financial companies that it believed potentially posed systemic risk in the United States and designated them accordingly—as systemically important nonbank financial institutions.[174] Between 2012 and 2014, the FSOC designated GE Capital, AIG, MetLife, and Prudential as nonbank SIFIs; according to the legislation, the result of this FSOC designation was to port these nonbanks into the Fed's jurisdiction.[175] The Fed, in turn, would have discretion to fashion heightened regulatory and supervisory requirements for these nonbanks newly placed within its jurisdiction.[176]

Shortly after its designation, MetLife sued FSOC, alleging that the designation had been arbitrary and capricious.[177] And in 2016, the federal district court in D.C. agreed.[178] In its reasoning, the district court pointed out that the FSOC had not followed its own definition of what manner of "material financial distress" at MetLife would have caused "an impairment of financial intermediation or of financial market functioning that would be sufficiently severe to inflict significant damage on the broader economy."[179]

The court therefore concluded that the FSOC failed to "measure both the susceptibility of a nonbank financial company to financial distress and the potential for that nonbank financial company's financial distress to spread throughout the financial system," as it claimed it would do.[180] It bears emphasis that, for the purposes of this U.S. administrative law case, the court found it compelling to its conclusion that the "FSOC purposefully omitted any consideration of the cost of designation to MetLife," thus

172. Courts are generally deferential on arbitrary and capricious review. Jacob Gersen & Adrian Vermeule, *Thin Rationality Review*, 114 MICH. L. REV. 1355, 1356 (2016).

173. *See* Christina Parajon Skinner, *Regulating Nonbanks: A Plan for SIFI Lite*, 105 GEO. L.J. 1603 (2017).

174. Gersen & Vermeule, *supra* note 172, at 1382; *see* 12 U.S.C. § 5321.

175. *See* Skinner, *supra* note 173, at 1382, 1392–94.

176. *See generally* GOV'T ACCOUNTABILITY OFF., FIN. STABILITY OVERSIGHT COUNCIL, ASSESSING EFFECTIVENESS COULD ENHANCE REPONSES TO SYSTEMIC RISKS 6 (Sept. 2023), https://www.gao.gov/assets/gao-23-105708.pdf.

177. Zachary Tracer et al., *MetLife to File First Lawsuit Over Systemic-Risk Label*, BLOOMBERG (Jan. 13, 2015), https://www.bloomberg.com/news/articles/2015-01-13/metlife-to-file-first-lawsuit-over-systemic-risk-label.

178. MetLife, Inc. v. Fin. Stability Oversight Council, 177 F. Supp. 3d 219, 237 (D.D.C. 2016).

179. *Id.* at 237.

180. *Id.* at 228.

assuming "the upside benefits of designation (even without specific standards from the Federal Reserve) but not the downside costs of its decision."[181]

As measured against these standards, the substance of the Basel 3 endgame rule, and the process used to design it, seemed critically flawed. Three of these reasons we have already discussed and we now summarize them briefly again.

For one, there was no compelling *legal basis* for promulgating another Basel rule. As noted, the Dodd-Frank Act supplied the most obvious statutory basis for the 2013 Basel implementation rule.[182] The ILS Act, it is true, admonishes banking agencies to consult with their peers abroad, but it does not remove the agencies' need to exercise their discretion consistent with the APA.[183]

Second, the *factual support* for the reforms was weak. The initial Basel 3 rules were, after all, a direct response to U.S. banks' balance sheet problems (i.e., concerning capital, liquidity, and the duration of debt) that appeared to have led to and/or exacerbated the 2008 financial crisis.[184] The U.S. endgame proposed rule-making thus begged the question of whether bank regulators were acting in response to their commitments to Basel's regime but moving outside and beyond the confines of U.S. law.

And third, the proposed rule was clearly not *appropriately tailored* to the risks in the U.S. banking system. For instance, as discussed above, the market stresses used in the endgame's FRTB were redundant with the Fed's already implemented Global Market Shock.[185] By adding the FRTB, the United States would have begun to double-count market risk without justifying the belt-and-suspenders approach.

Beyond the weak legal and factual basis, or proportional design, there was one other major indication of an arbitrary and capricious rule—several

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181. *Id.* at 230.

182. The U.S. Endgame Proposal *supra* note 6, at 64028, 64034 (noting that "[t]he proposal would build on these initial reforms by making additional changes developed in response to the 2007–09 financial crisis and informed by experience since the crisis").

183. COMM. ON CAP. MKT. REGUL., REVISITING THE APPLICATION OF THE ADMINISTRATIVE PROCEDURE ACT TO BANKING SUPERVISION AND REGULATION (2021), https://capmktsreg.org/wp-content/uploads/2021/09/Revisiting-the-Application-of-the-APA-to-Banking-Supervision-09.20.2021.pdf.

184. David Wessel, *What Is Bank Capital? What is the Basel III Endgame?*, BROOKINGS (Mar. 7, 2024), https://www.brookings.edu/articles/what-is-bank-capital-what-is-the-basel-iii-endgame/.

185. Letter from Andy Barr, Chair, Subcomm. on Fin. Insts. & Monetary Pol'y, to Jerome H. Powell, Chairman, Bd. of Governors of the Fed. Rsrv. Sys. (Oct. 26, 2023), https://www.federalreserve.gov/SECRS/2024/May/20240528/R-1813/R-1813_020124_158317_419284112725_1.pdf.

of the components were "gold-plated" versions of the Basel standard and illogically designed.[186]

The operational risk requirement is perhaps a prime example. The generic term 'operational risk' gained widespread currency with the advent of Basel 2.[187] It began as a "residual category, something left over"[188] after market and credit risk had been quantified. This characteristic of operational risk as a *bricolage* is evident in the loss categories included in it. These categories range from "losses arising from an unintentional or negligent failure to meet professional obligations to specific clients or from the nature or design of a product" to "losses arising from loss or damage to physical assets by natural disaster or other events."[189] It seems that a diverse set of risks has been bundled together to justify higher capital requirements,[190] and indeed Basel 2's operational risk capital requirements were substantial.[191]

The Basel 3 endgame proposal worsened this situation. The banking agencies estimated that their proposed changes in operational risk capital requirements alone would cause total risk weighted assets for affected banks to increase by $2 trillion, thus requiring more than $170 billion in additional capital to meet them.[192] Even the worst affected bank in its worst year did not suffer operational risk losses exceeding fifty percent of the new capital

186. Guowei Zhang et al., *The Federal Reserve Should Remove "Gold -Plating" in the Basel III Endgame*, SIFMA (Nov. 8, 2023), https://www.sifma.org/resources/news/blog/the-federal-reserve-should-remove-gold-plating-in-the-basel-3-endgame/.

187. MICHAEL POWER, ESRC CTR. FOR ANALYSIS OF RISK AND REG., DISCUSSION PAPER NO. 16, THE INVENTION OF OPERATIONAL RISK (2003), https://eprints.lse.ac.uk/21368/1/DP16.pdf, calls Nick Leeson, the rogue trader who brought about the failure of Barings bank in 1995, the "true author and unwitting inventor of operational risk" in that the sudden demise of Barings was "marshalled to construct a 'history' of operational risk, and to serve as a paradigm[atic] example of operational risk failure."

188. *Id.*

189. BASEL 2, *supra* note 52, at Annex 7.

190. Power's version of this is that "multiple elements combine [in the Basel 2 operational risk framework] to create a new hybrid regulatory and managerial practice" which represents "a fantasy perhaps of hyper-rational management for the global banking system." *See* POWER, *supra* note 187, at 16–17 (internal citation omitted).

191. The new rules added approximately 15% to capital requirements for globally systemically important banks and required more than $400 billion of Common Equity Tier 1 capital to meet them when they came into force in 2016. This was despite actual losses being less than a quarter of this amount in the worst year in which data was collected. *See* Peter Sands et al., *Rethinking Operational Risk Capital Requirements* (Harv. Bus. Sch., Working Paper No. 2016-06, 2016), https://www.hbs.edu/behavioral-finance-and-financial-stability/Documents/2016-06%20Rethinking%20Operational%20Risk%20Capital%20Requirements.pdf (referencing percentage added to capital requirements and amount of CET1 capital in pages 3, 6, and 9).

192. The proposal removes Basel 2's modelling approach for calculating operational risk capital requirements, the advanced measurement approach, replacing it with a revised standardized approach. *See* U.S. Endgame Proposal, *supra* note 6, Table 11, at 64168. The estimate of the increase in capital required uses an average target capital ratio of 8.8% (comprised of 4.5% minimum plus the 2.5% buffer and applicable GSIB surcharges). BANK FOR INT'L SETTLEMENTS, THE CAPITAL BUFFERS IN BASEL III – EXECUTIVE SUMMARY (2019), https://www.bis.org/fsi/fsisummaries/b3_capital.pdf.

requirement.[193] It is clear that the safety standard being targeted was substantially larger than that in other areas of capital, especially once it is realized that additional capital requirements for operational risk arise through the Federal Reserve's stress testing exercise, too.[194]

The calculation of capital requirements for operational risk also represents one of the areas where the U.S. agencies have gone beyond, or "gold plated," the final Basel 3 standard.[195] The international standard includes the notion of an "internal loss multiplier" for operational risk.[196] This optional feature[197] increases capital requirements for institutions which have a history of more severe operational risk losses in a particular area, but decreases them where the institution has a proven history of low operational risk losses.[198] The U.S. agencies' proposal adopted the increase but floored the internal loss multiplier at one, thereby making it impossible for banks to benefit from good operational risk management and creating a greater impact on banks with low historical operational risk losses.[199]

Another issue, reflecting the differential impact of regulation on bank business lines, concerns fee-based activities such as asset management and mortgage servicing.[200] Here, the operational risk loss history across large U.S. banks is particularly low when compared to the endgame capital requirement, and increases in fee income directly drive increases in capital

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193. *See* Francisco Covas, *About Excessive Calibration of Capital Requirements for Operational Risk*, BANK POL'Y INST. (Oct. 30, 2023), https://bpi.com/about-excessive-calibration-of-capital-requirements-for-operational-risk/.

194. *Id.*

195. A good example of U.S. gold-plating—a common phenomenon—is the overall impact on capital requirements: the Basel proposals were intended to be broadly capital neutral, but the U.S. ones increase capital requirements for large banks by 19% on average. *Basel III Endgame and the Cost of Credit for American Business*, BANK POL'Y INST. (Jan. 10, 2022), https://bpi.com/basel-iii-endgame-and-the-cost-of-credit-for-american-business/.

196. *See* BASEL 3 ENDGAME, *supra* note 101, at 129.

197. Unusually for a Basel standard, and reflecting the controversy around the internal loss multiplier, jurisdictions can choose to fix this parameter at one, and the EU has chosen to do so. *See* Directorate-Gen. for Fin. Stability, Fin. Servs. & Cap. Mkts. Union, *Latest Updates on the Banking Package*, EUR. COMM'N (Dec. 14, 2023), https://finance.ec.europa.eu/news/latest-updates-banking-package-2023-12-14_en.

198. BCBS, BASEL FRAMEWORK, OPE25 - STANDARDISED APPROACH (2023), https://www.bis.org/basel_framework/chapter/OPE/25.htm.

199. *See* Bobby Bean et al., *The Basel III Endgame – Implications for Operational Risk*, FORVIS MAZARS (Aug. 23, 2023), https://www.forvis.com/forsights/2023/08/the-basel-iii-endgame-implications-for-operational-risk?.

200. These costs will then be passed on to clients. For example, the American Bankers Association estimates that the increase in costs to the average home buyer in the United States due to the operational risk proposals would be $1,632 over the life of their loan. *See* Warren Hrung & Clifford Rossi, *End-User Impact of the Basel III Endgame Operational Risk Capital Requirements*, AM. BANKERS ASS'N (Apr. 2024), https://www.aba.com/-/media/documents/staff-analysis/b3e-ops-risk-end-user-impact-april-2024.pdf.

requirements.[201] Thus, banks will be discouraged from providing these relatively low-risk services.

In addition to gold-plating Basel's operational risk rules, the first proposed U.S. endgame rule also gold-plated credit risk for residential mortgages, retail exposures, exposures to bank and credit unions, and exposures to small business.[202] While the proposed U.S. rule placed a risk weight of 100% for corporate loan exposures, the EU had at the time set them at 65%; clearly, Europe made the political calculation that deviating from the Basel agreement in the interest of promoting corporate and small enterprise lending is more important than rote conformance.[203]

As a final indication of an arbitrary and capricious rule, the proposed endgame rule was woefully lacking in cost-benefit analysis. Although the rule acknowledges that it "would have the effect of modestly increasing capital requirements for lending activity" and that "a slight reduction in bank lending could result from the increase in capital requirements," it also concluded that "the economic cost of this reduction would be more than offset by the expected economic benefits associated with the increased resiliency of the financial system."[204] Yet that is impossible to know because no one can predict the source of the next financial crisis. Likely, it will not stem from the same risks as the 2008 financial crisis but rather from some other "unknowable unknown" event.[205]

The shaky legal and factual basis for implementing the Basel 3 endgame raises the question, why? Were the U.S. banking regulators being pulled along with Basel's tide, despite the lack of clear U.S. authorizing law and no U.S.-specific factual basis in support? Or were those regulators using the Basel superstructure as cover to accomplish something more than its

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201. *See* Katie Collard et al., *A Modification to the Basel Committee's Standardized Approach to Operational Risk*, BANK POL'Y INST. (May 4, 2022), https://bpi.com/wp-content/uploads/2022/05/A-Modification-to-the-Basel-Committees-Standardized-Approach-to-Operational-Risk.pdf.

202. Notably, the United States had gold-plated Basel 3 already. "For example, the largest 33 banks in the U.S. are subject to a stress capital buffer, which is determined from the supervisory stress test results, and is about 1 percentage point higher than Basel's capital conservation buffer of 2.5 percent on average." *Basel III Endgame and the Cost of Credit for American Business*, *supra* note 195; Pierluigi Bologna & Anatoli Segura, *Integrating Stress Tests Within the Basel III Capital Framework: A Macroprudentially Coherent Approach*, 3 J. FIN. REGUL. 159, n.19 (2017).

203. As the Bank Policy Institute has explained, "[t]he European approach eliminates all instances in which a 100% risk weight would be assigned to a firm whose actual risk justifies a lower risk weight. This appropriately lowers the cost of borrowing for these firms." *Basel III Endgame and the Cost of Credit for American Business*, *supra* note 195; *see* Thomas Poppensieker et al., *Basel III: The Final Regulatory Standard*, MCKINSEY & CO. (Apr. 18, 2018), https://www.mckinsey.com/capabilities/risk-and-resilience/our-insights/basel-iii-the-final-regulatory-standard (noting approaches differ between European countries, as some Nordic countries "rely heavily on internal models that produce low risk weights" while others, like Italy and Spain, "place greater reliance on standardized approaches and produce overall higher risk weights under internal models").

204. *See* U.S. Endgame Proposal, *supra* note 6, at 64167.

205. JOHN KAY & MERVYN KING, RADICAL UNCERTAINTY: DECISION-MAKING BEYOND THE NUMBERS 3, 7 (1st ed. 2020).

minimums require? Either way, Congress should be able to interrogate the nature of the Basel bargain and ensure any related regulation is anchored in U.S. law and consistent with U.S. interests.

2. Legislative Oversight

There are constitutional issues here. Aside from the parameters set by the APA, insofar as rules shaped at Basel ultimately find their way into U.S. law, the U.S. Constitution compels congressional oversight of that process. The Constitution's Article I gives Congress *exclusive* legislative authority.[206] This means that Congress may delegate some responsibility to U.S. administrative agencies, like the banking regulators, to "fill in the details" of a statute so that it can be properly enforced.[207] However, Congress cannot abdicate its legislative power by excessive open-ended delegation. That risk is already high with banking regulators, given their broadly worded mandates.[208] The risk is then heightened concerning the regulators' work at Basel because it is difficult for Congress to learn how the various interests of that organization's members come together to shape the standards, principles, and guidelines that emerge.[209]

The BCBS is, as has been discussed, part of a "regime complex."[210] The Committee itself is composed of central banks and other bank supervisory organizations. The Committee reports up to an "oversight" committee, composed of the Group of Governors and Heads of Supervision.[211] And, as noted previously, the entire organization sits within the BIS, which is owned and governed by the world's leading central banks.[212]

The decision-making at Basel is not transparent. The principal members of the Committee delegate and sub-delegate to deputies and staff. Between the Committee's four annual meetings, sub-groups meet to "discuss proposals and lay the groundwork for issues to be discussed at the main group."[213] The chairs of these groups are various senior-level officers or

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206. U.S. CONST. art. I.

207. *See, e.g.*, Whitman v. Am. Trucking Ass'ns, 531 U.S. 457, 474 (2001).

208. *See* Christina P. Skinner, *Central Bank Activism*, 71 DUKE L.J. 247, 293 (2021).

209. *Policy Development and Implementation Review*, BANK FOR INT'L SETTLEMENTS (Apr. 14, 2018), https://www.bis.org/bcbs/review_process.htm?m=83.

210. *See* Karen J. Atler & Kal Raustiala, *The Rise of International Regime Complexity*, 14 ANN. REV. L. & SOC. SCI. 329, 331 (2018) (citing the definition of a regime complex as "an array of partially overlapping and nonhierarchical institutions that includes more than one international agreement or authority").

211. *See Basel Committee Organisation and Governance*, BANK FOR INT'L SETTLEMENTS, https://www.bis.org/bcbs/organ_and_gov.htm?m=81 (last visited Mar. 13, 2025).

212. *See Statutes of the Bank for International Settlements*, BANK FOR INT'L SETTLEMENTS, ch. iv, art. 27 (Nov. 7, 2016), https://www.bis.org/about/statutes-en.pdf.

213. *International Cooperation to Modernize Financial Regulation*, *Hearing before the Subcomm. on Sec. & Int'l Trade & Fin., S. Comm. on Banking, Hous., & Urban Affs.*, 111th Cong. (2009) (statement of Governor Daniel K. Tarullo).

staff from the members' central banks or supervisory authorities.[214] As previously noted, these groups are in turn supported by "working groups" comprised of "technical experts" from the members; the groups' membership is not publicly disclosed.[215] It is within this constellation of committees, groups and working groups that the Basel standards develop.

Basel's taskforces, meanwhile, study issues that are important to the Committee in anticipation of future standards or guidelines on the topic. Formally, they "provide specific and expert assistance within a determined time frame where needed."[216] Here, the Committee advances what can only be described as special interests. Many of these interests inevitably will reflect the national priorities of some consortium of members. But they may not always be compatible with U.S. law, and this can present some tension.

Presently, for example, the BCBS has constituted a Task Force on Climate-Related Financial Risk.[217] The work of this task force includes taking stock of how well or poorly member jurisdictions are working to address climate change through their banks, and how effectively members' bank supervisory policies are geared toward addressing climate risk.[218] This scoping work aims toward the eventual development of more concrete requirements for the member jurisdictions. In the case of climate, the taskforce intends to "investigate the extent to which climate-related financial risks can be addressed within the existing Basel framework, identify potential gaps in the current framework and consider possible measures to address them."[219] Given the extent to which the Fed's statutory mandate limits its range of movement to address climate change, this could force the U.S. bank supervisors into an awkward position within Basel or in respect of Congress.[220] How will they choose?

It should further be noted here that the Basel Committee operates by consensus.[221] What is that power dynamic like? How can Congress disaggregate what interests from foreign bank supervisors (and other institutions, including other transnational bodies) have shaped the metes

214. *Basel Committee Groups*, BANK FOR INT'L SETTLEMENTS, https://www.bis.org/bcbs/mesc.htm (last visited Feb. 2, 2025).

215. *Policy Development and Implementation Review*, *supra* note 209.

216. *See id.*

217. *See* Kevin Stiroh, Exec. Vice President of the Fed. Rsrv. Bank of N.Y., The Basel Committee's Initiatives on Climate-Related Financial Risks, Speech at the 2020 IIF Annual Membership Meeting (Oct. 14, 2020) (transcript available at https://www.bis.org/speeches/sp201014.htm).

218. Here, the United States is represented by a co-chair who is a senior staff member at the Federal Reserve Bank of New York. *Id.*

219. Press Release, Bank for Int'l Settlements, Basel Committee Publishes Analytical Reports on Climate-Related Financial Risks (Apr. 14, 2021), https://www.bis.org/press/p210414.htm.

220. *See* Christina Parajon Skinner, *Central Banks and Climate Change*, 74 VAND. L. REV. 1301, 1301 (2021) (discussing the Federal Reserve's lack of congressional mandate to address climate change and questioning whether the Federal Reserve's tools would be, in any event, fit for such purpose).

221. *See* Lee, *supra* note 76.

and bounds of the various Accords? Without the ability to answer these questions Congress cannot exercise meaningful oversight of the agencies' work to implement what comes out of Basel.

C. *The Policing of Dissent from the Committee's Approach*

Basel 1 was broadly a success. It limited cross-border regulatory arbitrage, dramatically reduced the risk of an international race to the bottom on banking standards, and increased the safety of the riskiest internationally active banks.[222]

Basel 2's record is more mixed. On the positive side of the scorecard, it diminished (but did not eliminate) the use of securitization to artificially inflate capital ratios and provided a more risk-sensitive approach to the measurement of credit risk for regulatory purposes. Its disclosure requirements made banks less opaque. But it also reduced the comparability of banks, and hence the confidence of investors, due to the widespread use of modelling. Its treatment of some credit risks was imprudent, notably those of residential mortgages, and its reliance on credit rating agencies to assess credit risk was naïve. It was blind to the importance of funding liquidity risk. And it permitted some non-equity securities to count as bank capital which turned out to have no or little loss-absorbency.[223]

Basel 3's record is similarly mixed. Increases in the quality of capital resources and a focus on the importance of (funding) liquidity risk are to be welcomed, given the issues in Basel 2. However, the new Accord is unnecessarily complex and poorly designed in many places;[224] and yet, it seems extraordinarily difficult to revise.

Given the mixed track record of the Accords' success, one might wonder about the nature of discussion and debate that preceded the decision-making. In this Section, we turn to the institutional features that limit dissent in the Basel rule-making. These include a formal program for

222. *See* Caio Ferreira et al., *From Basel I to Basel III: Sequencing Implementation in Developing Economies* (Int'l Monetary Fund, Working Paper No. 19/127, 2019), https://www.imf.org/-/media/Files/Publications/WP/2019/WPIEA2019127.ashx; Posner, *supra* note 45.

223. *See* Andrea Resti & Andrea Sironi, *Regulation of the Financial Sector: What Future for Basel II?*, 8 CESIFO DICE REP. 3, 3 (2010).

224. *See* Jane E. Ihrig et al., *How Have Banks Been Managing the Composition of High-Quality Liquid Assets?*, FED. RSRV. BANK ST. LOUIS REV., Third Quarter 2019, at 177. The liquid asset buffers banks are required to hold under the liquidity coverage ratio cannot be used, and hence are simply a cost, not a mitigant of liquidity risk. *See also Liquidity Coverage Ratio Disclosure Standards*, BANK FOR INT'L SETTLEMENTS (2013), https://www.bis.org/publ/bcbs272.pdf. The inclusion of Treasury repo in the leverage ratio has pushed intermediation of probably the most systemically important market in the world out of the banking system. Jan Willem van den End & Mark Kruidhof, *Modelling the Liquidity Ratio as Macroprudential Instrument*, 14 J. BANKING REG. 91 (2013). The calculation of the add-ons for globally systemically important banks excessively penalizes some areas of bank activity, such as providing risk management services to clients, while others, such as concentration in the provision of payment services, are under-charged.

censoring jurisdictions that deviate from the Basel orthodoxy, a social mechanism that discourages individual bank regulators from expressing their concerns, and the political economy of the Committee.

1. The Regulatory Consistency Assessment Program

The spread of the Basel Accords has been wide. Not only have all twenty-eight member countries implemented the main planks of Basel 3,[225] but there has also been substantial adherence, even for low- and lower-income countries that are not members of the Committee.[226] Moreover, even when a member country has opposed a policy in transnational negotiations, they have typically implemented it once it was agreed.[227]

Compliance with the Accords is policed by a Regulatory Consistency Assessment Program (RCAP). The RCAP monitors the "adoption of Basel 3 standards by member jurisdictions, assesses the consistency of implementation across BCBS member jurisdictions, and considers whether these implementations have led to consistent outcomes."[228] In particular, it makes jurisdictional assessments to "review the extent to which domestic regulations are consistent with the minimum Basel requirements agreed by the Committee and help identify material gaps in such regulations."[229] Jurisdictions seem to be willing to permit assessments under the RCAP and seek to avoid negative ones.

The RCAP poses a serious challenge to both the claim that the Basel Accords are merely soft law, which countries choose to implement as they deem fit, and to the democratic legitimacy of bank prudential regulation. It implies that the Committee views itself as having the mandate to impose prudential standards on countries, despite never having been granted this authority.

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225. *See* BANK FOR INT'L SETTLEMENTS, PROGRESS REPORT ON ADOPTION OF THE BASEL REGULATORY FRAMEWORK (2021), https://www.bis.org/bcbs/publ/d525.pdf. This report states that at the end of September 2021, all twenty-seven member jurisdictions have risk-based capital rules, Liquidity Coverage Ratio regulations, and both capital conservation and countercyclical capital buffers in force, while twenty-one have implemented the revised leverage ratio.

226. *See* THE POLITICAL ECONOMY OF BANK REGULATION IN DEVELOPING COUNTRIES: RISK AND REPUTATION (Emily Jones ed., 2020) (reporting some measure of implementation of "the latest and more complex international standard" by twenty-two out of forty-five such countries).

227. *See generally* DEUTSCHE BUNDESBANK, MONTHLY REPORT: JANUARY 2018 (2018), https://www.bundesbank.de/resource/blob/667544/a0b3163136e1e059eaaee27171884982/472B63F073F071307366337C94F8C870/2018-01-monatsbericht-data.pdf (describing the EU's position in the output floor negotiations); Coen, *supra* note 147.

228. *See* BCBS, *RCAP: Role, Remit and Methodology*, BANK FOR INT'L SETTLEMENTS, https://www.bis.org/bcbs/implementation/rcap_role.htm (last visited Mar. 21, 2025).

229. *Id.*

2. The Place of the BCBS in the Sociology of Financial Regulation

Financial regulation is a professional career. It requires a substantial degree of specialization and expertise. Thus, one might expect some features of other professions to manifest among regulators. Fortunately, there is a substantial body of literature which identifies five key features of a profession. This establishes an analytical framework for the sociology of professions whose features are: social status, external power, delimitations on the profession, autonomy in professional decision-making, and social closure.[230]

Financial regulators fit well into this framework: as central bankers or employees of government agencies, their social status is not low. Regulation certainly has the power to influence the financial system. Only employees of a fixed, small set of bodies can contribute to rule-making, so there are hard limits on the profession. Moreover, this group has substantial—we would argue too much—autonomy to form regulation. Perhaps the most interesting aspect is social closure: this means that the professionals form a distinct cadre with their own values and myths. Social closure occurs between bank regulatory agencies, not just within them, as policy makers often spend substantial periods working with their peers in other agencies. This international practice creates a transnational network of shared professional understandings, sometimes called an "epistemic community."[231]

The literature suggests that there are "powerful socialization effects at work within peer networks"[232] and that these act to discourage heterodoxy.[233] Status among rule-writers is gained by schooling in the knowledge created by rule-writing, and by participating in the process. This knowledge is then used to protect the boundaries of the profession. Bank regulators not only know about bank regulation and define it, but they also have professional incentives to defend it against challenge.[234] And they gain status by so-doing, emulating their seniors.[235] Thus, the nature of financial

230. *See* Mike Saks, *Defining a Profession: The Role of Knowledge and Expertise*, 2 PROS. & PROFESSIONALISM 1 (2012); Leonard Seabrooke & Eleni Tsingou, *Distinctions, Affiliations, and Professional Knowledge in Financial Reform Expert Groups*, 21 J. EUR. PUB. POL'Y 389, 399–401 (2014) (providing a perspective specifically on financial regulation).

231. Seabrooke & Tsingou, *supra* note 230, at 402–04; *see also* Peter Haas, *Epistemic Communities*, *in* OXFORD HANDBOOK OF INTERNATIONAL ENVIRONMENTAL LAW 698–716 (Lavanya Rajamani & Jacqueline Peel eds., 2d ed. 2021).

232. JONES, *supra* note 226, at 81.

233. *See, e.g.*, Romano, *supra* note 14, at 25.

234. Brummer, *supra* note 75, at 285 (discussing the reputational pressure for regulators to adhere to agreements their employers have been party to).

235. Statements like "[b]ut the benefits to global financial stability of Basel III can *only* be fully realized if these global minimum standards are implemented across jurisdictions" form such exemplars. Pablo Hernández de Cos, Chairman of the BCBS, Basel III: The Implementation Imperative, Keynote

regulation as a profession and the type of networks formed by regulators create a cadre of experts who are incentivized to defend their colleagues' work both domestically and transnationally. It also contributes to the stickiness of regulation[236] because regulators defend standards they have been involved in drafting particularly zealously.

3. *The Political Economy of the Basel Committee*

The finance literature tends to treat financial regulation as a problem of risk management or of incentives.[237] These insights are helpful, but there are other perspectives. Some come from the political economy community,[238] and we turn to these next.

One important question in this literature concerns the growth of regulation, and especially transnational regulation, [239] as a mode of governance. This has been investigated empirically, and the reasons for it have been probed.[240] Broadly, four factors emerge to explain the rise of the "regulatory state": the value of expert technocratic advice; the advantage of pre-committing to policy consistency by granting a large measure of independence to a specialist agency; the limited political salience of most regulatory issues in the absence of a crisis, and hence the difficulty of commanding legislators' attention for them; and the benefit for politicians of having an independent agency to blame if things do go wrong.

Address at the 15th BCBS-FSI High-Level Meeting for Africa on Strengthening Financial Sector Supervision and Current Regulatory Priorities (Jan. 30, 2020), https://www.bis.org/speeches/sp200130.pdf.

236. This unhelpful phenomenon is noted in Roberta Romano, *Regulating in the Dark*, 1 J. FIN. PERSP. 2 (2013) (acknowledging the ratcheting up of regulations because it is much easier to enact new rules than to revise old ones).

237. *See, e.g.*, Henri Fraisse et al., *The Real Effects of Bank Capital Requirements* (Eur. Systematic Risk Bd., Working Paper No. 47, 2017), (finding that on average "a 1 percentage point increase in capital requirements reduces lending by 10%"); *see also* Skander J. Van den Heuvel, *The Welfare Cost of Bank Capital Requirements*, 55 J. MONETARY ECON. 298, 298-320 (2008); Malherbe, *supra* note 47; Rafael Repullo, *Capital Requirements, Market Power, and Risk-taking in Banking*, 13 J. FIN. INTERMEDIATION 156 (2004); David VanHoose, *Theories of Bank Behavior Under Capital Regulation*, 31 J. BANKING & FIN. 3680, 3680–97 (2007).

238. *See, e.g.*, David Howarth & Lucia Quaglia, *The Comparative Political Economy of Basel III in Europe*, 35 POL'Y & SOC'Y 205, 205–14 (2016); JONES, *supra* note 226; Stefano Pagliari & Kevin Young, *The Interest Ecology of Financial Regulation: Interest Group Plurality in the Design of Financial Regulatory Policies*, 14 SOCIO-ECON. REV. 309, 309–37 (2016); Verdier, *supra* note 17.

239. *See generally* Kenneth W. Abbott & Duncan Snidal, *The Governance Triangle: Regulatory Standards Institutions and the Shadow of the State*, *in* THE POLITICS OF GLOBAL REGULATION 44, 44–88 (Walter Mattli & Ngaire Woods eds., 2009) (mapping the diversity of transnational regulatory organizations).

240. *See* John Braithwaite, *The Regulatory State?*, *in* THE OXFORD HANDBOOK OF POLITICAL SCIENCE 407, 409 (Robert Goodin ed., 2011); Michael Moran, *Understanding the Regulatory State*, 32 BRIT. J. POL. SCI. 391, 391–413 (2002); Cass R. Sunstein, *Paradoxes of the Regulatory State*, 57 U. CHI. L. REV. 407, 407–41 (1990).

The growth of the regulatory state has not been without problems. Many of these problems center around control and accountability.[241] Thus, there is a vibrant literature on the design of legitimacy-enhancing mechanisms for regulatory agencies, and on regulatory capture.[242] Equally important is a strand of work on the tendencies of regulatory agencies to extend[243] and defend their own power[244] and to develop their own agenda, which reflect the inevitable growth of the rule set once a cadre of professional rule-writers has been empowered. As Martin Lodge puts it, "concern emerged whether regulatory developments were driven more by the self-interest of regulatory agencies than the intentions of politically accountable law-givers."[245]

These issues are evident in the BCBS. Another phenomenon that has emerged from it is the prominent role of a group of financial regulation experts largely employed by banks and trade associations who serve as its principal interlocutors whenever comment is sought.[246] This professional network of individuals with bank-policy-relevant expertise speak the technical language in which consultations are framed and have the knowledge of prior policy necessary to understand its context.[247] They too form part of the epistemic community of bank regulation. Unfortunately, this also means that they are incentivized only to carry out dialogue with the

241. *See* Julia Black, *Calling Regulators to Account: Challenges, Capacities and Prospects*, *in* ACCOUNTABILITY IN THE CONTEMPORARY CONSTITUTION 51 (Nicholas Bamforth & Peter Leyland eds., 2013); James Brassett & Eleni Tsingou, *The Politics of Legitimate Global Governance*, 18 REV. INT'L POL. ECON. 1, 1–16 (2011); Colin Scott, *Accountability in the Regulatory State*, 27 J. L. & SOC'Y 38, 38–60 (2000).

242. *See* Ernesto Dal Bó, *Regulatory Capture: A Review*, 22 OXFORD REV. ECON. POL'Y 203 (2006); *but see* William J. Novak, *A Revisionist History of Regulatory Capture*, *in* PREVENTING REGULATORY CAPTURE: SPECIAL INTEREST INFLUENCE AND HOW TO LIMIT IT 25 (David Moss & Daniel Carpenter eds., 2013), Giandomenico Majone, *The Regulatory State and its Legitimacy Problems*, 56 REIHE POLITIKWISSENSCHAFT/POL. SCI. SERIES 1, 1–17 (1998) (Austria).

243. Regulators often "operate less as technical experts alongside other technical experts, than as policy entrepreneurs, that is, as advocates who are willing to invest their resources — time, energy, reputation, money — to promote a position . . . ." Giandomenico Majone, *The Rise of the Regulatory State in Europe*, 17 W. EUR. POL. 77, 90 (1994) (internal quotation omitted).

244. A key element of this regulatory defense is regular exhortation of the dangers of not complying with the regulators' rules. One form this has recently taken with the BCBS are speeches insisting that "it is critical that member jurisdictions implement the outstanding Basel III standards in full and consistently, and as soon as possible." *See* Pablo Hernández de Cos, Chair of the BSBS, Two Truths and a Myth in Banking Regulation, Keynote Speech at the Eurofi High Level Seminar Ghent (Feb. 23, 2024), https://www.bis.org/speeches/sp240223.pdf. The consistency of this refrain is evident from an examination of the history of speeches by Basel Committee officials: as far back as 2011, Nout Wellink, then Chairman of the BCBS, was insisting that Basel 3 "must be implemented in a full and timely manner." *See* Nout Wellink, Chairman, BCBS, Basel III: A Roadmap to Better Banking Regulation and Supervision, Remarks at the FSI High-Level Meeting on the New Framework to Strengthen Financial Stability Regulatory Priorities (May 24, 2011), https://www.bis.org/speeches/sp110524.pdf. Conspicuous by their absence in such exhortations is any explanation as to why such implementation is indeed critical for financial stability.

245. Martin Lodge, *Accountability and Transparency in Regulation: Critiques, Doctrines and Instruments*, RESEARCHGATE (2007), https://www.researchgate.net/publication/30528322.

246. MURPHY, *supra* note 12, at 286.

247. *Id.* at 291–92, 309.

BCBS within a "window" of acceptable discourse. Their professional status depends on continued access to the Committee, so they cannot afford to offend Committee members. This leads to an inverse regulatory capture phenomenon,[248] whereby industry experts on bank regulation accede to the Committee's authority, paradigm, and framing of the regulatory problem, limiting the extent of their dissent.[249]

Finally, the political economy literature also focuses on when states cooperate on rule-making and when their approaches diverge, which raises issues of state competition and cooperation in transnational policy construction.[250]

Together, these perspectives provide helpful insights on the kinds of pathologies that scholars have observed or theorized in the behavior of regulatory agencies. They suggest the need for states to regularly assess whether the institutional arrangements of national and transnational regulation are meeting their needs, and to critically assess regulators' necessarily self-interested claims for the optimality of the current policymaking process, its technocratic nature, and its (lack of) democratic oversight.

IV. RECOMMENDATIONS FOR REFORM

As the prior Part explained, the Basel process is untethered to any body of binding, predictable, transparent law that might provide guardrails around its actions to ensure that global administrative law norms are observed. The BCBS is opaque, not subject to public scrutiny, and it sits outside of any mechanism of democratic accountability. Its actors have vested interests in increasing the amount of regulation over time and in defending their past actions. Meanwhile, the supposed virtues of international cooperation and harmonization are often used on the domestic level by prudential regulators as a shield against challenges to their decision to implement Basel standards.

These problems have resulted in a significant disconnect between what is required by basic norms of global governance arrangements and domestic law on the one hand, and the process and substance of the BCBS' work on the other. This gap indicates the need for both a reconsideration of Basel's

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248. *See* David Murphy, *Our Lessons Have Returned: Insights into Post-Crisis Financial Regulation from Mandatory OTC Derivatives Clearing Policy* (LSE L., Soc'y & Econ. Working Papers, Paper No. 6/2020, 2020), https://ssrn.com/abstract=3561599 (introducing the term "inverse regulatory capture").

249. Daniel Mügge describes the situation like this: "experts may agree because all members of one epistemic community [share] a particular policy paradigm that limits the breadth of their thinking." *See* Daniel Mügge, *Limits of Legitimacy and the Primacy of Politics in Financial Governance*, 18 REV. INT'L POL. ECON. 52, 58 (2011) (internal citations omitted).

250. *See, e.g.*, Quaglia, *supra* note 62; Eleni Tsingou, *Transnational Veto Players and the Practice of Financial Reform*, 17 BRIT. J. POL. & INT'L REL. 318, 318–34 (2015), https://research-api.cbs.dk/ws/portalfiles/portal/58851660/Tsingou.pdf; Verdier, *supra* note 17.

work by its members (and, more specifically, by the democratically elected representatives within the member states), and for serious reform.

The issues identified with the BCBS are known risks in regulatory theory, as discussed earlier.[251] As Majone says: "a highly complex and specialized activity like regulation can only be monitored and kept politically accountable by a combination of control instruments: legislative and executive oversight, strict procedural requirements, public participation and, most importantly, substantive judicial review."[252] The accountability mechanisms for the BCBS are weak, its procedural requirements are flimsy, and public participation is only invited at the whim of the Committee. It has never been subject to judicial review and likely cannot be.[253] Given this and the substantial incentives for bank regulators to defend the Committee's prescriptions and to extend its power, the potential for transnational bank regulation to overstep the bounds of legitimacy is obvious.

It would be impossible to defend abolishing prudential rules for banks. The moral hazard created by the presence of deposit insurance and lender-of-last-resort facilities, the externalities associated with episodes of financial instability, and the opacity of banks, which can lead to sudden losses of confidence in them, all suggest the need for capital and liquidity regulation. However, some prudential regulation is excessively burdensome, inefficient, and even counterproductive. When such rules are imposed by standard-setters who have limited accountability, whose processes do not promote the legitimacy of their work, and whose errors are seldom corrected, opposition is both principled and appropriate.

In conclusion, we identify some of the components of an alternative approach to prudential regulation. Specifically, we consider the design of bank capital rules, the accountability of the BCBS and its rule-making process, and bank prudential regulation in the United States.

A. Recommendations for Bank Capital Regulation

The basic premise of capital regulation in Basel—that capital requirements should be set at a level that reflects the potential losses a bank could sustain, given the risks it runs—is unhelpful. Modern internationally active banks are far more likely to fail due to the loss of the confidence of depositors or the wholesale funding markets than due to a jump to

251. *See supra* Part III.C.

252. Majone, *supra* note 243, at 93.

253. *See supra* notes 71–73. *See NML* Capital Ltd. v. BIS, 5A_360/2010, Judgment of 12 July 2010, ATF 136 III 379, ILDC 1547 (2010) (Switz.) (affirming the BIS' broad immunity from Swiss law).

insolvency.[254] Banks which breach their minimum capital requirements will likely lose the confidence of their investors, as discussed in Part II.A. Therefore, minimum capital requirements should be set below the level which funding markets would likely require—probably much lower than the Basel 3 level.[255]

Bank capital above the minimum *does* provide going-concern loss absorbency. Therefore, in addition, banks should be expected to maintain a large buffer of additional capital above the minimum during ordinary conditions. This buffer could be set by stress testing, and its use to absorb losses would not trigger regulatory intervention.[256] In order to prevent such use from creating a bank run in the funding markets, the ordinary-conditions level of the buffer required by authorities should not be disclosed.[257]

Incentives for banks to reduce their provision of vital services to the real economy, such as risk transfer or capital markets intermediation, should be eliminated. This includes the FRTB and related requirements,[258] as well as the problematic operational risk requirements discussed in Part III.B. above.

This revised paradigm for bank capital regulation would have large benefits. It would make banks more robust because far more of their capital would be loss-absorbing, and the risk of loss-of-confidence-driven runs on bank funding would be reduced. It would dramatically simplify prudential policy, reducing compliance costs. It would largely eliminate the procyclicality of capital requirements, allowing banks to provide much more

254. Even for the paradigmatic example of the stress of an over-leveraged financial institution, Lehman Brothers, the proximate cause of failure was the firm's inability to raise cash: by "early [on] September 14[, 2008,] . . . . Lehman no longer had sufficient liquidity to fund its daily operations." Lehman failed the following day. *See* ANTON VALUKAS, 1 LEHMAN BROTHERS HOLDINGS INC. CHAPTER 11 PROCEEDINGS EXAMINER'S REPORT 12 (2011).

255. Capital required to meet the minimum and bail-in debt together should be sufficient to absorb losses in resolution, so work would be needed to assess this amount.

256. Basel 3 does have a "capital conservation buffer," but this has a suboptimal design because its use would require disclosure, leading to a loss of confidence. Basel 3 also permits authorities to impose a "countercyclical buffer," which is intended to counteract the procyclicality of capital ratios. However, history indicates that authorities are unwilling to build up the buffer sufficiently in good times, as minimum capital requirements are set too high, and they are reluctant to release it in all but the most stressed of conditions, reducing its usefulness. Finally, the "G-SIB buffer" is not a buffer at all, but part of minimum capital requirements for affected banks. European Central Bank, *Macroprudential Bulletin* (Oct. 2020), https://www.ecb.europa.eu/press/financial-stability-publications/macroprudential-bulletin/html/ecb.mpbu202010_1~01c4f1a5f4.en.html.

257. *See* Sam Woods, Bufferati*,* Speech at City Week 2022 (Apr. 2022), https://www.bankofengland.co.uk/speech/2022/april/sam-woods-speaking-at-city-week-2022-developments-in-prudential-regulation-in-the-uk (offering a similar proposal).

258. *See* ISDA & SIFMA, Comment Letter Re: Regulatory Capital Rule: Amendments Applicable to Large Banking Organizations and to Banking Organizations with Significant Trading Activity (Jan. 16, 2024), https://www.sifma.org/wp-content/uploads/2024/01/ISDA-SIFMA-Comment-Letter-January-16-2024-Basel-III-Endgame.pdf.

support to the economy when it is recovering from stress.[259] Minimum capital requirements would act less as an incentive for banks to alter their activities, and thus restore the banking system to being a robust facilitator of economic activity in many areas where it has been forced by regulation to withdraw. Finally, it would make individual bank regulators more accountable, as the design of suitably—but not excessively—stressful stress tests would clearly be their responsibility alone. "Basel made me do it" would no longer be an excuse.

B. Recommendations for BCBS Rule-Making

As previously discussed, administrative law considerations pinpoint issues with the prudential rule-making process. These are independent of the question of the role of minimum capital requirements and buffers discussed in the last section. They instead relate to how rules are made.

At the level of the BCBS, global administrative law suggests a deficit of accountability, consultation, disclosure, and proportionality. Democratically accountable governance arrangements are needed for the Committee. Its methods, decisions, and performance should be subject to regular review informed by independent expert analysis in member states. The Committee's consultation process is voluntary and has highly questionable efficacy in improving rules.[260] Mandatory consultation requirements should be imposed: before rule-making, to gain input on the necessity for it; during the rule-making process, to assess the methodology under development and the data used in calibration; and at the proposal stage, to consider impacts and potential unintended consequences.

The Committee should be required to justify its decisions at each stage based on fully disclosed (though perhaps anonymized) data. If the Committee claims to act technocratically, it should have nothing to fear from stakeholder challenges. Finally, the Committee should be required to produce a detailed proportionality analysis alongside each proposal. This should clearly articulate: the supervisory goal; the range of means considered to meet it; why the chosen method is believed to be the least onerous one

259. Stress testing should produce inherently anticyclical capital requirements as the potential decline of the economy immediately after a downturn is less than in ordinary conditions. The procyclicality of capital resources remains a problem. One way to mitigate this would be to allow increases in loan loss provisions—which are now highly procyclical under relatively new accounting standards which require provisioning based on expected losses—to reduce capital requirements. *See* BCBS, *The Procyclicality of Loan Loss Provisions: A Literature Review* (Bank for Int'l Settlements, Working Paper No. 39, 2021), https://www.bis.org/bcbs/publ/wp39.pdf.

260. Murphy, *supra* note 12.

necessary to meet the objective; why its use is proportionate given the costs involved; the potential benefits; and the risks to achieving the goal.[261]

The approach in the BCBS of writing highly detailed, prescriptive regulation is not the only one in use in transnational rule-making. Both the International Organization of Securities Regulators and the Committee on Payments and Market Infrastructures use a principles-based approach to transnational standards.[262] Indeed, the Principles for Financial Market Infrastructures, promulgated by these two organizations,[263] form a coherent and largely successful body of regulation which shapes individual jurisdictions' approaches but does not fully determine it.[264]

The adoption of a principles-based approach and the acknowledgement at the BCBS level that countries should adopt banking regulation which is appropriate for their financial systems would also have the added benefit of rendering the BCBS Regulatory Consistency Assessment Program unnecessary.[265] This program should be abolished.

C. Recommendations for the Prudential Regulation of Banks in the United States

The United States has substantial power in the BCBS.[266] It is, in the language of political economy, a "veto player."[267] The United States should use this power to demand the changes to the BCBS processes outlined above, with the threat of withdrawal if the Committee does not comply.

It should be an uncontroversial proposition that federal agencies should comply with the relevant administrative law. However, as we have seen, this requires substantial changes to their processes for domestic rule-making in

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261. David Zaring's suggestion of the enactment of International Administrative Procedure Act would be one effective way to make these changes. *See* ZARING, *supra* note 12.

262. *See* Julia Black, *The Rise, Fall and Fate of Principles Based Regulation* (LSE Legal Stud. Working Paper No. 17/2010, 2010), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1712862 (discussing principles-based financial regulation).

263. *See* Comm. on Payments & Mkt. Infrastructures & Int'l Org. of Sec. Comm'ns, *Principles for Financial Market Infrastructures*, BANK FOR INT'L SETTLEMENTS (2012), https://www.bis.org/cpmi/info_pfmi.htm.

264. Compare, for instance, the Commodity Futures Trading Commission's (CFTC) rule-making for central counterparties in 17 C.F.R. pt. 39, with the EU's provisions in the European Market Infrastructure Regulation, Regulation (EU) No. 648/2012, 2012 O.J. (L 201) 1. Both are shaped by the Principles for Financial Market Infrastructures, *supra*, but both are substantially more detailed than them. The U.S. and EU rule sets are different, in part due to differing regulatory inherences in the two jurisdictions—but they achieve broadly comparable regulatory outcomes. *See* European Commission, *EC Adopts Equivalence Decision for CCPs in USA* (2016), https://ec.europa.eu/commission/presscorner/detail/es/IP_16_807.

265. *See supra* Section III.C.1.

266. *See* MICHAEL KRIMMINGER, THE AMERICAN ROLE IN THE BASEL COMMITTEE ON BANKING SUPERVISION: WHAT NEXT? (2018), https://ssrn.com/abstract=3194133. While there is evidence for Krimminger's argument that prior BCBS Accords have been broadly positive for the United States, that does not mean either that future ones will be too, or that the federal agencies do indeed have the authority to negotiate agreements in Basel which truly bind the United States.

267. *See* Tsingou, *supra* note 250.

prudential regulation as well as reform of the transnational regulatory process. Domestic rule-making cannot be guided by the principle of "Basel is the minimum" and should instead be determined by the needs of (and hence the rule set and calibration appropriate for) the U.S. financial system.[268] This requires both changes to the rule-making processes, including the inclusion of consultation with affected stakeholders that genuinely affects outcomes, and the use of rigorous cost-benefit analysis to select the least onerous means needed to achieve the agencies' objectives (given the likely bank failure modes and what prudential regulation can reasonably be expected to achieve).[269]

Banks' reluctance to use judicial review as a tool to incentivize the agencies' compliance is understandable: trade associations or other interested parties should consider this form of challenge in egregious examples of agency non-compliance with administrative law.[270]

Cost-benefit and other forms of data analysis, if carefully conducted, can suggest regulatory calibrations which achieve a desired safety standard for the current financial system. It is harder to assess the least onerous means needed to achieve an objective and to determine how the system will react in response to regulation.[271] Moreover, considering the complexity of both the financial system and the regulation which is applied to it, errors in

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268. In a study examining the differing responses of U.S. and EU banks to the initial Basel 3 rules, Sami Ben Naceur and Caroline Roulet conclude that implementing this capital and liquidity regulatory framework for "all banks could have counterproductive effects on post-2008 bank-lending-growth" and that regulators should "consider heterogeneous banks' characteristics and behaviors to determine what types of regulations should be implemented and enforced, in order to promote stronger financial stability and strengthen banks' core functions as credit providers." The same regulatory framework does not fit all countries. *See* Sami Ben Naceur & Caroline Roulet, *Basel III and Bank-Lending: Evidence from the United States and Europe*, 39 J. FIN. STAB. 1, 17 (2018).

269. The Swiss regulator's report into the failure of Credit Suisse, FINMA, LESSONS LEARNED FROM THE CS CRISIS, (2013), https://www.finma.ch/en/~/media/finma/dokumente/documentencenter/myfinma/finma-publikationen/cs-bericht/20231219-finma-bericht-cs.pdf, makes it clear that the bank "met the regulatory capital requirements" and "met the regulatory requirements for liquidity and held comfortable liquidity buffers," yet "this capital adequacy situation was unable to contain or prevent the massive crisis of confidence" in the bank when there were "very rapid and widespread liquidity outflows." There is no reason to think that twenty percent more capital would have changed this dynamic. The problem was that investors doubted the bank's strategy, governance and risk management—all issues of supervision, not prudential regulation.

270. The suit by the International Swaps & Derivatives Association against the CFTC's rule-making on position limits under the Dodd-Frank Act is a good example of such a challenge. The plaintiffs argued that the CFTC misinterpreted its statutory authority "in imposing position limits without making a determination that such limits are necessary and effective in relation to the identifiable burdens of excessive speculation on interstate commerce." In other words, while the Commission had statutory authority to impose limits, it had to demonstrate that the limits it was proposing achieved the goal of relieving the burden of sudden or unreasonable price fluctuations. *See* Int'l Swaps & Derivatives Ass'n v. U.S. Commodity Futures Trading Comm'n, 887 F. Supp. 2d 259, 264 (D.D.C. 2012).

271. *See* Jonathan Masur & Eric Posner, *Cost-Benefit Analysis and the Judicial Role*, 85 U. CHI. L. REV. 935 (2018) (discussing cost-benefit analysis generally); *see also* Coates, *supra* note 171 (discussing financial regulation specifically); John H. Cochrane, *Challenges for Cost-Benefit Analysis as a Framework for Financial Regulation*, 43 J. LEGAL STUDS. S63 (2014).

drafting are inevitable. In order to address these issues, it is vital that there are mechanisms "to ensure that there will be serious, comprehensive reassessment after a fixed period, and that information regarding the impact of regulatory alternatives can be gathered in the interim to aid in the reassessment."[272] Regulators cannot be expected to be unbiased assessors of their own work, so we recommend that an independent office of regulatory performance is set up to conduct these studies.[273]

In the short term, U.S. federal banking agencies should articulate their target safety standards, making clear the trade-offs they are assuming between higher resource requirements and economic growth. They should seek congressional approval for their chosen trade-off. Once this approval has been obtained, they should make available all data used to calibrate their new proposal and seek expert comment on the least onerous means needed to achieve their desired level of bank safety. They should provide a detailed analysis of their response to comments, redesign their proposal based on them, and perform a detailed cost-benefit analysis of their revised proposal. At the same time, banking agencies should propose indicators of the performance of their approach, commit to publishing them regularly, and undertake to revise their proposal if it is not achieving the target level of bank safety or if banks are failing to serve the real economy as effectively as intended.

V. CONCLUSION

This Article has explained the origins of the BCBS' role in international cooperation to reduce the potential for cross-border regulatory arbitrage. The Basel Committee's Accords have evolved from relatively simple measures in 1988, which did not bind most internationally active banks, to a huge, highly detailed set of requirements in 2019, which, when implemented, will constrain every area of bank activity. At the same time, the Committee's rule-making processes remain rooted in the 1980s: we have seen that they are opaque, poorly justified, unsupported by cost-benefit analysis, and often far from the least onerous means necessary to achieve the intended goal.

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272. Roberta Romano, *Regulating in the Dark and a Postscript Assessment of the Iron Law of Financial Regulation*, 43 HOFSTRA L. REV. 25, 92 (2014) (making a convincing case for the mandatory inclusion of sunsetting clauses in financial regulation).

273. Julia Black and one of us (Murphy) have both separately suggested such an office: *see Who Watches the Watchdogs? Improving the Performance, Independence and Accountability of UK Regulators*, Hearing of the UK Parliament Industry and Regulators Committee, 1st Report of Session 2023-24, https://publications.parliament.uk/pa/ld5804/ldselect/ldindreg/56/5608.htm (last accessed May 30, 2024).

This has resulted in substantial and unnecessary burdens on the real economy.[274] The BCBS' rules are also, as we have seen, often based on political compromise rather than on optimal design. Their writers and implementers are largely unresponsive to criticism or evidence.[275] This reduces the legitimacy of bank prudential regulation to the point where a loss of authority is inevitable, and challenge becomes necessary.

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274. Estimates of the impact of Basel 3 on the real economy vary. Patrick Slovik and Boris Cournède, studying the initial Basel 3 proposal, suggest an impact on GDP growth of −0.05 to −0.15 percentage point per annum. *See Macroeconomic Impact of Basel III* (Org. for Econ. Cooperation & Dev., Working Paper No. 844, 2011). Ben Naceur & Roulet, *supra* note 268, at 17 find the Basel 3 encourages substitution "out of retail-and-other-loan assets, and into risk-free, more liquid government bond securities." In a meta-analysis, Jarko Fidrmuc and Ronja Lind find that GDP "is expected to decrease by about -0.2% in response to one percentage point increase in the capital ratio," but that there is "a high degree of uncertainty surrounding the estimates of primary studies." *See* Jarko Fidrmuc & Ronja Lind, *Macroeconomic Impact of Basel III: Evidence from a Meta-Analysis*, Beiträge zur Jahrestagung des Ausschusses für Wirtschaftssysteme und Institutionenökonomik im Verein für Socialpolitik, Münster (2016) (Ger.). Finally, looking at various estimates of the cost of borrowing under the Basel 3 initial package, Ingo Fender and Ulf Lewrick find an increase of between 5 and 80 basis points for a one percent increase in the capital ratio. *See* Ingo Fender & Ulf Lewrick, *Adding It All Up: The Macroeconomic Impact of Basel III and Outstanding Reform Issues* (Bank for Int'l Settlements, BIS Working Papers, Paper No. 591, 2016), https://www.bis.org/publ/work591.pdf.

275. Romano, *supra* note 272, at 56, makes the case for a four-part "iron law" of U.S. financial regulation: "(1) enactment is invariably crisis driven, adopted at a time when there is a paucity of information regarding what has transpired; (2) resulting in "off-the-rack" solutions often poorly fashioned to the problem at hand; (3) with inevitable flaws given the dynamic uncertainty of financial markets; (4) but arduous to revise or repeal." We find this account to be persuasive and suggest that the Basel 3 endgame proposal is a good example of it.