3RD GLOBAL ADMINISTRATIVE LAW SEMINAR

Private parties' involvement in prudential banking regulation – some thoughts on the underlying accountability mechanisms

Larisa Dragomir

Viterbo, June 15-16, 2007

Private parties' involvement in prudential banking regulation – some thoughts on the underlying accountability mechanisms

Contribution by Larisa Dragomir

1. Introduction

After a long gestation period involving complex consultation and negotiation processes, the Basel Accord comprising the revised international capital framework (referred to also as Basel II) has become a reality[1] and is on its way to being implemented. Drawn up by the Basel Committee on Banking Supervision, the Accord is the outcome of intense interaction among domestic and international, public and private actors, a process that has been held to enhance accountability and legitimacy of international regulators' work through improved transparency[2].

The Basel II Accord is a long, sophisticated and technical document that lays down the outline for supervisory regulation governing the capital adequacy of internationally active banks. Controversies still surround the substantive choices made by the Basel Committee and the national implementation process focuses on ways for refining and adapting the international standards to domestic specificities[3]. Going beyond intricate expert debates on technical aspects, we observe there is a certainty about the implementation of Basel II into domestic legal and regulatory orders - that is the express conferral of a role to private actors in the setting of capital standards.

This paper will try to delineate, against the background of the new supervisory approach displayed by the Basel II Accord, the different patterns of involvement of private parties in the design of prudential standards. After trying to ascertain the relevance of the prompted role of private actors in the calculation of capital requirements, we will inquire into the reasons behind such involvement and highlight the shortcomings. We endeavour to initiate an analysis of the criteria and procedures used for allowing such involvement and to suggest legal effects that may be attached to them. It is generally sought to examine whether the transferral of regulatory powers to private actors is accompanied by enough guarantees or proper mechanisms to ensure their reliability, which is essential for the observance of the fundamental objectives of prudential regulation, i.e. the maintenance of financial stability and depositor protection[4].

---

[1] The Basel Accord has been adopted in June 2004. A comprehension version of the Basel II Accord was issued on 4 July 2006 solely as a matter of convenience to readers without bringing new elements but simply compiling the June 2004 Basel II Framework, the elements of the 1988 Basel I Accord that were not revised during the Basel II process, the 1996 Amendment to the Capital Accord to incorporate market risks and the 2005 paper on the Application of Basel II to Trading Activities and the Treatment of Double Default Effects.

[2] The Basel process has been accurately scrutinized from the perspective of global administrative law by Michael S. Barr and Geoffrey P. Miller, "Global Administrative Law: The View from Basel", *European Journal of International Law* Vol.17, no.1, 2006, p.15-46

[3] Exemplificative are the issues raised during the implementation process in the EU and the US. See in this sense European Commission (2003), *Review of Capital Requirements for Banks and Investment Firms. Commission Services Third Consultation Pap*er. Explanatory Document, 1 July 2003 and Bruce Spitzer, "Et Tu, Basel Ia?", *Community Banker*, May 2006; 15, 5, p.42-49

[4] Prudential regulation, consisting mainly of capital adequacy rules, has two dimensions: primarily, at the micro level, it addresses the solvency and reliability of individual banks, and at the macro level, it is concerned with the stability of the whole banking system. The case for micro prudential regulation is

2. The new approach to prudential supervision stemming from the Basel II Accord

Globalisation and financial innovation encouraged by technological development have provoked significant changes in the nature and distribution of risks in the financial system. Consequently, regulators had to adapt to new developments in the banking markets, a process that has been designated as "regulatory modernisation"[5]. The revision of the international capital framework is part of these efforts and responds to the criticisms brought to the 1988 Capital Accord (Basel I) considered as inadequate for addressing actual risks faced by credit institutions[6].

The new Basel Accord intends to address the shortcomings of its predecessor not only by responding to the calls for greater risk-sensitiveness in the calculation of capital requirements but also by proposing an overall complex regulatory strategy that does not rely exclusively on capital requirements. Thus, the Basel Committee has devised a three pillar capital framework consisting of minimum capital requirements, the supervisory review process (control of an institution's internal assessment process and capital adequacy) and market discipline (effective use of disclosure of information to strengthen market discipline as a complement to supervisory efforts). The three pillars are mutually reinforcing and have to be implemented concomitantly in order to achieve an efficient safeguard of the stability of financial intermediaries.

Although the second and third pillar are less developed than the capital adequacy provisions in the first pillar, due to their close interaction, they definitely contribute to highlighting an increased role for private parties in prudential policy. They also reflect the shift in prudential strategies away from rigid prescriptive rules setting precise quantitative standards towards more flexible norms, focusing on processes, objectives, qualitative standards and incentives[7]. Furthermore this complex three-pillar structure signals the fact that public regulators can keep the pace with rapid and complex developments and thereby ensure the safety and soundness of the banking system only in close cooperation with the industry and by stimulating the interest and vigilance of all market participants. Yet, although at the core of the debate on compliance and on

---

made especially by information asymmetries between banks and their customers and by the propensity of banks to hazardous behaviour due to safety net arrangements. Thus, minimal guarantees have to be established for maintaining consumer confidence and simultaneously keeping risk-taking at reasonable levels. The macro (or systemic) dimension of prudential bank regulation responds to concerns raised by spill-over aspects and information deficiencies regarding the whole financial system. No clear line of distinction can be drawn between these two dimensions, as they are strongly interrelated; however their relevance becomes apparent with regard to supervisory issues. – Larisa Dragomir, *European Prudential Banking Regulation and Supervision*, PhD Thesis, EUI, March 2006, p.62

[5] Heidi Mandanis Schooner and Michael Taylor, "United Kingdom and United States Responses to the Regulatory Challenges of Modern Financial Markets", 38 *Tex. Int'l L.J.* 317-346, 2003, p.318

[6] Criticism of the 1988 international regulations referred to the crude classification of credit risk, the employment of rigid rules and inaccurate formulas, and the categorical assessment of asset risk irrespective of the standing of the counterparty concerned. In this sense, Heribert Hirte, Tobias A. Heinrich, "Principles and technical instruments for prudential regulation" in *Diritto bancario communitario*, edited by Guido Alpa, Franceso Capriglione, UTET, Torino, 2002, p.462. and the seven deadly sins of the 1988 Accord as denounced by Heath Price Tarbert, "Are International Capital Adequacy Rules Adequate? The Basel Accord and Beyond", *University of Pennsylvania Law Review*, Vol.148, 2000, p.1802 ff

[7] On this aspects see Jonathan Ward, *The Supervisory Approach: A Critique*, Cambridge Endowment for Research in Finance, Working Paper No.2/2002, p.37 ff, http://www.cerf.cam.ac.uk/publications/files/The%20Supervisory%20approach-a%20critique.pdf

private vs. public enforcement of prudential regulation, we will not focus on the role of private parties under the supervisory review and market discipline pillars. We shall make reference to these only to the extent they may be able to support the role of private actors under the minimum capital requirements pillar.

Our inquiry purports to address the role envisaged for private parties under the first pillar of the Basel Accord. Capital requirements still constitute the central pillar of prudential regulation, as they serve for absorbing losses which are not matched by a sufficient volume of profits, for inspiring public confidence, covering uninsured depositors and constitute an important yardstick for competent authorities' assessment of the solvency of a credit institution[8]. Before entering into the details of the various prudential approaches and of the conditions underpinning the involvement of private parties, let us briefly outline the main elements of the Basel Accord. These are the definition of regulatory capital (the constituents of capital – their quality and the conditions attached to their use for prudential purposes), the risk-weighting system (the methodologies for determining risk weights to be assigned to the various bank activities) and the minimum capital ratio of 8% (designating how much capital banks should reserve for prudential purposes). The risk-based capital ratio is calculated by dividing the qualifying capital (the numerator of the ratio) by its risk-weighted assets (the denominator – whereby assets are weighted in relation to credit, market and operational risks)[9]. The new Basel Accord does not affect the minimum target ratio, or the nominator, but proposes a reform of the risk weighting system, whereby it changes the modalities for determining weightings in relation to credit risk, aligns market risk provisions and introduces operational risk in the calculation of capital.

The new framework of minimum capital requirements puts forward a regulatory menu, whereby banks may chose from different methodologies for calculating their capital in relation to credit risk[10], in accordance with their degree of sophistication, their resources and subject to approval by the supervisory authorities. The standardised approach is basically a revision of the approach contained in the 1988 Accord, rendered more risk-sensitive because of the mandated recourse to credit ratings provided by external credit assessment institutions (when risk-weighting the assets). The standardised approach can be considered the default as it will be used whenever a bank does not apply for a more advanced risk calculation approach. It does not require authorisation for the bank but presupposes prior recognition of the institutions providing external ratings. As an alternative and subject to various conditions and explicit approval, banks may make use of the internal ratings-based approach with its two modalities (foundation and advanced), which allows them to use their own internal risk estimates for calculating the necessary capital. Capital requirements for

---

[8] On the importance of banking capital requirements see Duncan E. Alford, "Basel Committee International Capital Adequacy Standards: Analysis and Implications for the Banking Industry", 10 *Dick. J.Int'l L.*, 189, 1992, p.1992. See also the Preamble of the Codifying Banking Directive (Directive 2000/12 of the Council and the European Parliament), intend 33

[9] This ratio has been reflected in a simple formula as bank's capital ratio (minimum 8%)=total capital / (credit risk + market risk + operational risk) (assets) – Mamiko Yokoi-Arai, "Basel II in the national sphere", *Law in transition online*, October 2005, www.ebrd.com/country/sector/law

[10] Credit risk, referred to also as counterparty risk, consists of the possibility of failure of the client of a bank- that is the impossibility of the debtor to reimburse the bank in accordance with his contractual commitments. For such a risk to be evaluated it is essential to take account of the nature of the counterparty and of the existence of guarantees which will reduce or eliminate losses in case of a default of a debtor – Dominique Augustin, "Credit Risks in European and International Regulations", in G. Ferrarini, *Prudential Regulation of Banks and Securities Firms*, Kluwer Law International, 1995, p.141

market risk[11] permit also a choice between the use of internal models for measuring value at risk for larger and more sophisticated banks (under various criteria) and the more general standardised method – the building block approach for the rest. The newly introduced operational risk[12] measurement also relies on three alternative methodologies: the basic indicator approach (the most rudimentary), the standardised approach (more refined in relation to business lines, but requires the fulfilment of eligibility criteria) and the internal measurement approach (based on the banks' own assessment of the exposure and subject to explicit approval).

It is observed that the new accord enrols two types of private actors in the regulatory process. On the one hand there are the external credit assessment institutions and, on the other hand, the regulated entities themselves – the banks. Overall, the spirit of Basel II is in the sense of encouraging the move towards the use of internal risk models. This reflects the propensity of supervisory authorities to rely ever more on the contribution of private parties and the acceptance of hybrid (private and public) capital requirements. Nevertheless, it is also explicitly acknowledged that reliable internal risk models suppose the employment of numerous resources that could not be afforded by small or simple banks. Hence, a default risk measurement as provided by Basel I needs to be also available and is likely to continue to be relied upon by the vast majority of banks. Consequently, regulators considered (in the case of the most important banking risk – the credit risk) that the way to make such default standardised approach more risk-sensitive is by underpinning risk weights with credit ratings released by external credit assessment institutions (ECAIs). Thereby a new private actor gains an important saying in determining the actual capital requirements.

3. Relevance of and rationale for private parties' involvement

We have observed that ECAIs' ratings or banks' internal ratings can influence only the denominator of the capital ratio and also we noted that such influence can be exercised only under some predetermined conditions. Both, external credit assessments and internal ratings can be used only for determining individual credit quality and not overall risk exposure of the bank. However, this does not exclude that their impact on the actual capital required to banks may be decisive.

In the case of the standardised approach the predefined and non-realistic risk categories[13] of the 1988 Accord will be replaced by external credit assessments. Thus, in order to benchmark the risk corresponding to a loan made to a central government, a public institution, a bank, a multilateral development bank a security firm or a corporate entity, the bank will use the rating of the borrower's creditworthiness as

[11] Market risks are those related to market operations, especially to the fluctuation of certain elements of these operations, e.g. variations of the interest rates and foreign exchange rates.

[12] Operational risk is defined as the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events. This definition includes legal risk, but excludes strategic and reputational risk.

[13] For instance, claims by all private obligors including commercial loans were all assessed under Basel I at 100%, which implied that the same loan granted to an AA-rated company and to a BBB-rated one would require the same capital usage. See Jules Stewart, "Another Reason for Banks to Make Friends of Credit-Worthy", *Fin. Dir*., September, 17, 1999, available in 1999 WL 2027705. Furthermore, Basel I has been criticised (especially after the Mexico crises) for the favourable risk weightings assigned to OECD countries as compared to non-OECD countries, which encouraged investors to lend disproportionately to weak borrowers in the OECD, with little or no capital put aside against the risk of their default.

provided by an ECAI. Under Basel II ECAIs' ratings will correspond to a sliding scale of risk weights from 0% to 150%, whereby it is the task of the supervisory authorities to decide the correspondence between ECAIs' assessment categories and risk weights[14]. Loans to unrated entities are automatically assigned a 100% risk weight and would leave solvable entities very probably worth off than if they were rated. Also, there are several categories of risk weights that will continue not to be affected by ratings provided by ECAIs, such as claims included in the regulatory retail portfolio, claims secured by residential property, claims secured by commercial real estate and credit conversion factors for off-balance sheet items. Notwithstanding the limited incidence, it is undeniable that the use of credit ratings has the capacity, if the ratings are accurate, to ensure a more precise rating of risk, a decrease in regulatory arbitrage and more opportunities for the most solvent companies to borrow at lower interest rates[15].

As for the internal ratings-based (IRB) approach, it has been considered as "the next logical step toward accuracy and flexibility" as it "uses the same internal methods that are already commonly used for loan approval requirements and analysis of pricing and profitability"[16]. Under the Basel II Accord, banks that have received supervisory approval to use the IRB approach may rely on their own internal estimates of risk components[17] in determining the capital requirement for a given exposure. In some cases, banks may be required to use a supervisory value as opposed to an internal estimate for one or more of the risk components. The IRB approach is available in two modalities: the foundation option and the advanced one, whereby the former allows banks to use their estimates only with regard to one risk component (the probability of default), whereas the latter permits also the use of the other two defined risk components (loss given default and/or exposure at default).

Nonetheless, even in the case of the IRB approach there is still much scope for inputs from the supervisor. The IRB approach does not move towards a complete self-regulatory model, where private actors devise actual regulatory standards in the shadow of the State. It only makes an initial step in that direction by providing the public framework for a relatively open regulatory space, where private actors receive incentives for contributing to the regulatory substance given their better knowledge of the conditions. The achievement of the new regulatory framework is that it provides the legal basis for relating internal risk measurement systems and prudential supervisory tasks more closely and it implicitly underlines the potential value (at least from the point of view of risk-sensitiveness), and accuracy of banks own quantitative and qualitative assessment of individual assets.

Such a shift in regulatory strategy may be interpreted as pointing to the road ahead for prudential regulation: the delegation of the entire regulatory capital adequacy process to the regulatees themselves, through the recognition of the so-called credit risk

[14] This is called the mapping process and is further accompanied by rules applying in case of multiple assessments, of issuer versus issuance assessments, of domestic currency and foreign currency assessments, of short-term/long-term assessments, rules on the level of the assessment and on unsolicited ratings.

[15] See Heath Price Tarbert, "Rethinking Capital Adequacy: the Basel Accord and the New Framework", *The Business Lawyer*, Vol.56, 767-836, February 2001, p.805

[16] Ibid p.809

[17] The risk components include measures of the probability of default (PD), loss given default (LGD), the exposure at default (EAD), and effective maturity (M). The risk components and the asset classes are defined in the Basel II Accord.

models which are already used by complex financial institutions in order to determine their actual capital requirements.[18] The new capital framework, as yet, does not allow for the use of credit risk models, nevertheless an important transfer of regulatory responsibility to banks for assessment of capital adequacy already takes place through the IRB approach, which constitutes a substantial change.

The use of credit ratings has been characterised as a "breath of fresh air in a system now stale from regulatory imprecision"[19]. However regulatory reliance on credit ratings is not per se an innovation, almost all countries participating in the Basel Committee had already incorporated external credit ratings in their domestic regulations (although not necessarily in banking regulation)[20]. Also, it is already in the 90s that the practice of using internal risk evaluations was acknowledged, relying on agreements between supervisory authorities and regulated banks as to the models and procedures to be used by the latter for evaluating assumed risks, and the sanctions the supervisors would impose in case of failure to observe the agreed terms of such agreement[21].

Yet, without being a "regulatory discovery" the explicit incorporation of private parties' external and internal ratings into international banking regulation is an important change and will have important consequences. It will consolidate recourse to private parties in the domestic banking regulations (where it already existed) and diffuse such regulatory mode to new countries. It will contribute to the flourishing of the rating industry on a global level and encourage the formation of banking groups capable of developing at low costs efficient internal rating systems. But above all, it explicitly recognises, once for good, that accurate risk measurement cannot be assured merely through preset risk categories and public supervision. As regards the costs attached to the reliance on private ratings, the quantitative impact studies have revealed overall a moderate increase of capital requirements in the case of the standardised approach and a decrease for the internal ratings based approach[22].

Understanding private parties' enrolment in prudential regulation brings us back to the very rationale behind such involvement: information asymmetry. Information deficiencies along with negative externalities (spill-over effects) are among the very

---

[18] Compared to internal rating models, which evaluate in accordance with more or less sophisticated methodologies only the creditworthiness of borrowers, credit risk models constitute complex processes involving procedures for determining the individual's bank target default risk- estimating the risk of the entire portfolio and activities for a specific time period and allocating sufficient capital to ensure a cushion up to the target default risk. See Tarbert op.cit. p.1820

[19] Heath Price Tarbert, op. cit., p.1831

[20] Bank of International Settlements, *Credit Ratings and Complementary Sources of Credit Quality Information*, BCBS Working Paper No.3, August 2000, Basel, BIS

[21] This so-called "pre-commitment approach" has been documented by Kupiec, H. and O'Brien, J. (1997), "The Pre-Commitment Approach: Using Incentives to Set Market Risk Capital Requirements", *Finance and Economics Discussion Series*, no.1997-14, Federal Reserve Board, Washington D.C., March.

[22] For the standardised approach the QIS3 reports a moderate overall (i.e., credit risk and operational risk) increase in regulatory capital requirements. Larger banks face an 11% and 6% average increase in the G10 and EU respectively, while smaller banks are confronted with a 3% and 1% increase respectively. The results are quite different for the IRB approaches. In the foundation IRB approach the average capital requirement for smaller banks decreases by 19% and 20% in the G10 and EU respectively, while it remains about the same for larger banks (3% increase in the G10 and 4% decrease in the EU)- as published on May 5, 2003 by the Basel Committee in an overview of global results with respect to the third Quantitative Impact Study (QIS3)

reasons for the adoption of prudential banking regulation[23]. Asymmetric information stemming from the time sequencing structure of financial contracts refers not only to the relationship between lender and borrower emphasising the insecurity of the former as regards subsequent repayment[24], but also to the relationship between supervisory authority and regulated banks. A bank, which is likely to be much more aware of its own risk characteristics could hide or distort information provided to the supervisor about its solvency, as well as imperceptibly alter its risk exposures over short periods. Supervisors, irrespective how diligent, have limited resources and a bounded regulatory capacity. The alternative to the use of broad abstract risk categories and the way to come closer to the actual risk position of a regulated entity is either to rely on entities that have a competitive advantage in information gathering or to trust the banks themselves.

Banks have traditionally been information specialists as this is at the core of their lending activities. Rating agencies are typical market institutions that have an information-creative, respectively, transaction cost-lowering role. Their main activity consists of checking and reporting regularly on the financial standing of single debtors and applying standardised stamps of quality to their creditworthiness. Accordingly, the main justification for private parties' involvement in prudential regulation is their very nature of "information specialists"[25].

Possession of information grants a strategic position that justifies participation in the regulatory process, which can be fragmented into the following components: setting standards, gathering information and modifying behaviour[26]. External and internal ratings are essential information inputs, indispensable for identifying problems and defining the attached prudential goals and ultimately devising prudential standards. Their use can be said to amount to a significantly extensive delegation of the determination of regulatory capital adequacy requirements and to ascribe a "hybrid" (public-private) character to prudential capital regulation.

4. Scepticisms regarding recourse to external and internal ratings

Along with the enthusiasm for enhanced risk-sensitiveness triggered by the enrolment of private actors in prudential regulation there is also a lot of criticism accompanying such delegation. Apart from general concerns related to the propensity of hybrid prudential regulation to fuel regulatory capture, the literature has outlined various critical aspects and potential shortcomings with regard to the role to be played by both, rating agencies and regulated banks.

---

[23] On the rationale for prudential banking regulation see Llewellyn David (1999), "The Economic Rationale for Financial Regulation", *FSA Occasional Papers in Financial Regulation*, April 1999; Benston, George J.(1998), "Regulating Financial Markets: A Critique and Some Proposals", *Hobart Paper* No.135, London, Institute of Economic Affairs; Benston, George J., "Is Government Regulation of Banks Necessary?", *Journal of Financial Research* 18:2/3 185-202, 2000, Kluwer Academic Publishers

[24] On this see Wörner, Ingo, *Europäische Bankenregulierung im Spannungsverhältnis zwischen Regulierungswettbewerb und Harmonisierungsbemühungen*, Schriftenreihe des Europa-Kollegs Hamburg zur Integrationsforschung, Nomos, Baden-Baden, 1. Edition, 2000,p.67

[25] White, L.J., "Bank Regulation in the United States: Understanding the Lessons of the 1980s and 1990s", 14 *Elsevier: Japan and the Word Economy*, 2002, 137-154, p.143

[26] Julia Black, "Enrolling Actors in Regulatory Systems: Examples from UK Financial Services Regulation",2003 *Public Law*, Spring, 63-91, p.67

As regards the reliance on external credit ratings, the literature has expressed doubts because of the risk that external credit assessments are "inaccurate, limited in scope, and prejudicial in their appraisals, thus acting as a barrier against swift regulatory intervention"[27]. It is said that rating agencies have mixed track records, which would indicate a questionable accuracy. Moreover they cover only the most financially active countries and it would take time to extend the ratings culture, whereas lack of experience in developing countries may affect the reputation of the whole industry and undermine the credibility of ratings. Furthermore, changing the nature of ratings by ascribing them regulatory value could unbalance the fragile equilibrium between rating agencies and their clients, increasing the incentives of the former to act in the interest of borrowers[28]. Also, it has been stressed that the rating agencies lack economic and political accountability, as they have been constantly able to avoid financial liability even in case of negligent behaviour and manage to escape democratic mechanisms of accountability, although they exercise influential authority in capital markets[29]. Last but not least the literature has constantly warned of the banks' incentives for ratings shopping[30].

The internal ratings based approach much praised for breaking with the past "one-size-fits-all" methodology of Basel I has also raised questions as to its effective capacity to improve regulatory capital requirements. Thus, such flexibility based on a bank's active risk management requires considerable resources that may only be committed by large financial institutions, hence there is limited impact. Further, unlike the internal VAR models for calculating market risks, there are data limitations concerning default and credit history, especially with regard to the developing countries, which will impinge on the accuracy of IRB estimates. The most acute concern about IRB is related to the potential for bank regulators to be captured by the industry and the fear that, failing to understand the intricacies of the internal models, regulators might be "effectively handing the reigns of regulation over to the regulated banks themselves"[31] without providing for the corresponding accountability. The specific complexity of internal models is very likely to reveal the limited capacities and resources of supervisory authorities. Additionally, internal models are protected by intellectual property rights and "their inner workings are shrouded in the utmost secrecy"[32].

The way these concerns are reflected in the Basel II Accord points to a central role for supervisory authorities, based on a specific relationship with private entities providing regulatory inputs. Supervisors are in a disadvantaged position as regards risk assessment, which implies they are also not in the position to evaluate the accuracy of private ratings used as regulatory input. In order to counterbalance such shortcoming they need to develop skills that allow them to base their relationships with the

---

[27] Heath price Tarbert (2001) op.cit, p.821

[28] *Improving the Basel Committee's New Capital Adequacy Framework: Joint Statement by a Sub-Group of the Shadow Financial Regulatory Committees of Europe, Japan and the U.S.*, June 14, 1999, http://www.aei.org/shdw/shdwBasel.htm

[29] Michael R.King; Timothy J.Sinclair, "Private Actors and Public Policy: A Requiem for the New Basel Capital Accord", *International Political Science Review*, Vol.24, No.3, July 2003, 345-362, p.352-353

[30] Karacadag, Cern and Michael W. Taylor, *The New Capital Adequacy Framework: Institutional Constraints and Incentive Structures*, IMF Working paper WP/00/93, Washington D.C, IMF, 2000, p.32

[31] Tarbert (1999), op.cit. p. 1835

[32] Tarbert (2001), op.cit., p.823

providers of such ratings on trust. Hence, supervisors would need to dispose of mechanisms that allow them to control the reliability of private rating providers and not so much the accuracy of ratings. These mechanisms should ensure that the supervisor gains insight into the organisation and procedures employed by these private parties.

In response to the above mentioned concerns, the Basel Committee has enshrined in the New Accord procedures that aim to ensure the reliability of private parties. The two procedures differ in their substance and reflect the different character and purposes underlying the interaction between regulatory authorities and external credit assessment institutions, respectively banks.

5. Recognition of external credit assessment institutions

Ensuring reliability of ECAIs departs from difficult premises resulting from the absence of a hierarchical relationship between banking supervisors and the private rating industry that developed exclusively as a consequence of market demands for information. Thus, any formal recognition of an ECAI for prudential purposes needs to duly take into consideration the fact that it has the sole objective of providing the basis for capital requirements' calculation and can by no means constitute a form of regulation or licensing of rating agencies[33]. This is a sensitive topic, particularly in Europe, where, as opposed to the U.S., the credit rating industry is not subject to government regulation. On the other hand, it is a choice of public policy to ascribe regulatory force to private credit ratings and thereby delegate regulatory power to the rating agencies without that the latter deliberately sought such role. Yet, the concrete exercise of such role depends on an explicit application by the ECAI to perform it and hence an implicit commitment to undertake it as it is expected to do. This means that without encroaching upon the independence of ECAIs the eligibility criteria should provide sufficient safeguards that private rating institutions act in line with the prudential policy objectives. Moreover, ratings have authority in the market as long as the members of the rating industry preserve a good reputation and guarantees against the emergence of conflicts of interest inherent to their professional activity[34] and eligibility criteria should ensure that recognised ECAIs respond to such prerequisites.

The recognition process of ECAIs as prescribed by the Basel II Accord gives to national supervisors the responsibility for determining whether an ECAI meets the eligibility criteria. It allows for the assessments of ECAIs to be recognised on a limited basis, e.g. by type of claims or by jurisdiction. The supervisory process for recognising ECAIs should be made public to avoid unnecessary barriers to entry[35]. In order to be eligible an ECAI has to file an application and provide evidence that would convince the supervisory authorities that it fulfils the 6 eligibility criteria[36].

[33] In this sense see the CEBS Guidelines for the recognition of external credit assessment institutions from 20 January 2006, http://www.c-ebs.org/pdfs/GL07.pdf

[34] Such conflicts of interest relate to their privileged access to inside information, the fact that they earn the bulk of their income from fees paid by those assessed by them and the practice of developing ancillary consultancy business related to the rating of specific clients – see European Parliament, Committee of Economic and Monetary Affairs, rapporteur Giorgos Katiforis, *Report on Role and methods of rating agencies*, Final A5-0040/29.01.2004, p.10

[35] Article 90 of the Basel II Accord (2006 comprehensive version)

[36] The 6 eligibility criteria are laid down at article 91 of the Basel II Accord (2006 comprehensive version).

The first criterion requires, under the exigency of objectivity, that ECAIs' methodology for assessing credit risk exposures be rigorous, systematic and subject to some form of validation based on historical experience[37]. Objectivity further demands that credit assessments are subject to ongoing review and responsive to changes in the financial conditions. By virtue of the independence requirement the ECAI needs to be free of any economic and political pressures, and in this respect the supervisor has to make sure that the composition of the board of directors, as well as the shareholder structure of the ECAI are not prone to generate conflicts of interest. As a third criterion, the demand for international access and transparency requires supervisors to recognise only those ECAIs that do not discriminate between domestic and foreign institutions as regards the availability of individual assessments[38] and, respectively, make their general methodology publicly available. The fourth eligibility criterion imposes on an ECAI to disclose the following information: its assessment methodologies, including the definition of default, the time horizon, and the meaning of each rating; the actual default rates experienced in each assessment category; and the transitions of the assessment. Disclosure requirements applied to ECAIs would thus reflect the new supervisory approach that encourages market discipline and promotes a disclosure culture affecting both regulators and regulated entities. The supervisors should be also convinced that ECAIs possess sufficient resources for ensuring high quality credit assessments, substantial ongoing contact with the senior and operational level of the assessed institution, as well as a combination of qualitative and quantitative approaches within their assessment methodology. Last but not least, supervisors have to judge the credibility of an ECAI by considering all the evidence supporting the previous criteria and demonstrating reliance on the ECAI's external credit assessments by independent parties (investors, insurers, trading partners), plus by scrutinising the internal procedures to prevent the use of confidential information.

The Basel Accord traces just these general lines of the recognition procedure and the principles reflecting the substantive criteria that will have to be considered for allowing private ratings to become regulatory inputs for the calculation of capital requirements. The details remain to be devised by national laws and in accordance with domestic administrative and regulatory practices. Important aspects are left to national discretion and might leave space to substantial differences in the implementation of the use of ECAIs' assessments. These refer, for instance, to the treatment in case of rejection of an application for recognition, the ongoing control of the maintenance of the eligibility criteria, the possibility and eventual conditions for withdrawing recognition and the attached effects, the liability issue.

Thus, it would seem that the Basel II Accord establishes a benchmark for attributing the regulatory label to external credit assessments. Recognition does not assume a constant dialog between the supervisor and the ECAI, but only an initial complex qualitative evaluation. The criteria imposed for eligibility to recognition are structural and should ensure reliability of assessments for a longer period. Yet, genuine accountability would also suppose the possibility for monitoring and enforcing such eligibility criteria. Given that the influence of ECAIs' assessments on the calculation of the actual capital requirement is substantial, we would qualify the Basel II

[37] It should also benefit from backtesting and should be established for each market segment for at least one, but preferably three years.

[38] However this does not mean that in order to be eligible an ECAI needs to assess institutions from more than one country.

Accord's provisions as insufficient for ensuring that ECAIs act in the long run as supervisors, banks, other market participants and depositors expect them to act. Such shortcoming, eventually aggravated in the jurisdictions that do not regulate the ratings industry, can be mitigated within the national contexts in which the use of external credit assessments is implemented.

6. Supervisory approval, monitoring and enforcement of the use of the internal ratings-based approach

Delegation of regulatory powers to the banks for calculating their own capital requirements is underpinned by a different context, characterised by a hierarchical relationship. Thus, the supervisory authority is, as a rule, the one in charge with the licensing of the bank and obliged by law to monitor its evolution and compliance. Furthermore the supervisory review pillar of the Basel II Accord reinforces a close dialog between supervisors and the supervised institutions and even assigns to supervisors roles that make them deeply involved in the micro decisions of risk management[39]. Thus, it comes at no surprise that the evaluation of the suitability of a bank to use the IRB approach and its endorsement are regulated in detail and supported by mandatory monitoring and enforcement requirements[40]. As an alternative to the default standardised approach, the IRB approach allowing for the use of internal rating system for the assessment of credit risk needs explicit approval from the supervisor[41].

Different from the principle-based eligibility requirements applying to ECAIs' recognition, the qualification of banks for the IRB approach is subject to very technical norms. These are set out systematically in 12 separate sections concerning: (a) composition of minimum requirements, (b) compliance with minimum requirements, (c) rating system design, (d) risk rating system operations, (e) corporate governance and oversight, (f) use of internal ratings, (g) risk quantification, (h) validation of internal estimates, (i) supervisory loss-given-default and exposure-at-default estimates, (j) requirements for recognition of leasing, (k) calculation of capital charges for equity exposures, and (l) disclosure requirements[42].

The provisions are highly technical and almost inaccessible to non-experts. The basic idea behind them is that approval to use an IRB approach can be given only if the competent authority is satisfied that the institution's systems for managing and rating credit risk exposures[43] are sound and implemented with integrity and, in particular, that they meet the requirements listed in the various articles. Such requirements are both quantitative and qualitative and often spelled out in the form of objectives that a qualifying bank's risk rating system has to fulfil. Remarkable (and more accessible to lawyers) are the articles dealing with the corporate arrangements that should underpin a bank applying for the IRB approach. These provisions combined with the detailed

[39] European Shadow Financial Regulatory Committee, *Bank Supervisors' Business: Risk Management or Systemic Stability?*, Statement n.16, Basel and Zurich, 12 May, 2003

[40] As opposed to the few articles that deal with the recognition process and eligibility criteria for ECAIs, the minimum requirements for the use of the IRB approach are spelled out in 161 articles – articles 387-538 of the Basel II Accord (2006 comprehensive version).

[41] Article 51 of the Basel II Accord (2006 comprehensive version)

[42] Article 387 of the Basel II Accord (2006 comprehensive version)

[43] The Basel II Accord uses the term "rating system" to designate all of the methods, processes, controls, and data collection and IT systems that support the assessment of credit risk, the assignment of internal risk ratings, and the quantification of default and loss estimates – article 394.

framework under pillar II regulating the interaction between supervisors and bank management for prudential purposes were characterised as "the emerging international regime of corporate governance for banking institutions"[44].

The Basel II Accord repeats several times that such minimum requirements have to be met at the outset and on an ongoing basis[45]. Moreover it insists on compliance and adjustment, as resulting from article 393: "There may be circumstances when a bank is not in complete compliance with all the minimum requirements. Where this is the case, the bank must produce a plan for a timely return to compliance, and seek approval from its supervisor, or the bank must demonstrate that the effect of such non-compliance is immaterial in terms of the risk posed to the institution. Failure to produce an acceptable plan or satisfactorily implement the plan or to demonstrate immateriality will lead supervisors to reconsider the bank's eligibility for the IRB approach. Furthermore, for the duration of any non-compliance, supervisors will consider the need for the bank to hold additional capital under Pillar 2 or take other appropriate supervisory action."

Considering the above mentioned aspects it seems that supervisory approval for the IRB approach is a complex process with many facets and relying on detailed yardsticks, which seeks to make sure that banks allowed to determine their own capital cushion are reliable. It is based on a steady dialog between the regulator and the regulated entity, which aims at warranting that all requirements, including those expressed under the form of objectives are correctly understood and transposed in the internal ratings system. Moreover supervisory approval is seen as part of a more complex assessment and implementation process that endeavours to ensure that the parameters agreed by a bank in order to qualify for the use of internal rating systems will be observed on a continuous basis. In this context enforcement is essential and the supervisor is endowed with instruments for action. Forbearance needs to be supported by a redress plan subject to supervisory approval. Overall such a regime would appear to indicate that banks are accountable towards supervisory authorities.

7. Some issues open to discussion

We have identified two patterns by which private parties may become involved in the regulation of capital adequacy: recourse to external ratings that enrols ECAIs and use of internal ratings that engages banks into the regulatory process. Regulatory inputs from both would affect only the nominator of the same capital ratio formula. The extent of such involvement varies, yet its impact on the calculation of the actual capital cushion is ascertainable in all cases, as it is reflected in the actual amount of regulatory capital that a bank needs to put aside. In order to qualify for participating in the regulatory process private parties pertaining to both categories need to fulfil a set of requirements and to obtain an authorisation from the supervisory authority.

The content of such requirements and the authorisation process and its monitoring and enforcement differ enormously for the two categories, with the ECAIs rather exempt from being held accountable to the supervisor after their recognition, whereas banks are subject to close ongoing control by the supervisors. Two issues come to our mind in this context. The first questions whether, given the similar implications of the use

[44] Kern Alexander, "Corporate Governance and Banking Regulation: the Regulator as Stakeholder"
[45] Article 388, 392, 395, 525 of the Basel II Accord (2006 comprehensive version), *CERF Working Paper* No.17, 2004

of external and internal ratings, it wouldn't be advisable to endow the banking supervisor with some control and enforcement instruments, so as to ensure also the maintenance of the eligibility criteria for ECAIs in the longer run. Such a system should take duly into account that ECAIs are third parties and part of an independent industry (eventually subject to own national regulations) for which reputation is a precious asset. Nevertheless, as they are not constrained, but apply on a voluntary basis for participation in the regulatory process it would seem fair to ensure that they continue to count as reliable. This is even more the case when considering that ECAIs may be prone to be captured by the entities they asses.

The second issue relates to the more impressive mechanism regulating the interaction between banks willing to use the IRB approach and banking supervisors. It questions whether the supervisory approval, monitoring and enforcement process can actually constitute a shield against the most worrisome concern implied by this approach: regulatory capture. Supervisors used to verify compliance, but under Basel II they are confronted with complex assessment of intricate models and processes for which banks have an a priori advantage in both technical competence and the knowledge of their specific techniques[46]. This requires supervisors to catch up and acquire the corresponding knowledge, as well as to participate in a reinforced dialogue with the regulated entities. However, in the context of dynamic and innovative financial markets, we have seen that the very rationale for the recourse to private parties comes from the bounded rationality of supervisory authorities and the need to make use of inputs provided by information specialists in order to evaluate accurately credit risks. Thus, the current solution does not seem to preclude regulatory capture and would call for adjustments.

As an option, we think that such adjustment could make use of the concept of regulatory contract, which in our view would emphasise the clear obligations of both parties (supervisor and regulated bank) and the sanction in case these obligations are not fulfilled. Put in simple words, this approach perceives regulation as a sort of contract concluded between the regulator and the bank. It has as a prerequisite the obligation of the regulator to establish a clear set of objectives and general principles, while leaving up to the banks the concrete modes of compliance with the regulatory objectives. It is in the interest of banks to choose their own procedure for satisfying the regulator's general requirements. Therefore, they may reduce compliance costs by adopting their own least-costly strategy. Further, banks are very familiar with their own particular circumstances and structures and know better how to address them. The bank may consequently choose its own procedure and submit it for approval to the regulator. Once the regulator has agreed with the bank on the modalities of satisfying the regulatory objectives and principles, the contract may be considered concluded. Such a contract requires the bank to deliver on its agreed standards and procedures, under the threat of sanctions in the case of non-performance of the contract.[47] In case of infringement of the contract, the regulator has a disciplining role, having also the option of withdrawing the choice from the bank, which then would be obliged to accept a standard (default) contract devised by the regulator. Under such an approach the regulator would not bother allocating resources for understanding intricate technicalities of the bank's procedures, but would focus on outcomes and the fulfilment of the assumed obligations.

[46] European Shadow Financial Regulatory Committee, op.cit., p.3

[47] See Llewelyn, D.T., "A Regulatory Regime for Financial Stability", Wien, Österreichische Nationalbank, Working Paper No.41, 2001. p.31

Finally, we would like to indicate shortly a couple of further research questions that would gain even more importance if prudential regulation were to move further towards internal credit risk models. An important one refers to whom these private parties should be held accountable. The mechanisms contained in the Accord refer only to their responsibility towards the supervisor, yet their activities affect ultimately all financial market participants and financial consumers. Additional research is needed to ascertain whether there is need for ensuring accountability towards these other parties and, if yes, under what form.

Last but not least, we consider that the liability issue would deserve a central role in any discussion about the involvement of private parties in the setting of prudential standards. Rating agencies have constantly managed to avoid liability, although this would not be at all justified in case of capture by the banking industry or gross negligence. Banks, on the contrary, are fully liable in case of insolvency. The question arises whether a close dialog between the bank and the supervisor in the framework of the IRB approach could somehow impinge on the liability regime applicable in case of the failure of a bank. Would it be possible for the bank to limit its liability by invoking compliance with the terms set during the process of supervisory approval and constantly monitored by the supervisor? Could such collaboration in devising the regulatory capital have the potential of removing eventual immunity from liability of the supervisor and make him subject to subsidiary or even in solidum liability? However, answering such questions would suppose to anchor them in national legal contexts and engage into a comparative research, a task that goes beyond the scope of the present paper.