

trade as well as in other areas of international law. As a result, not enough interdisciplinary expertise has been brought to bear on dispute settlement, especially since dispute settlement in international trade law is having a profound effect on the nature of the international trading regime and on the way in which states behave in this important area of international relations. These phenomena also have implications beyond the area of trade and for other areas of international law. Dispute settlement in international trade law should not be left to lawyers talking to each other.

The Evolution of the Trade Regime is an important work that heightens our understanding of the WTO and of the international trading regime. But there is scope for a follow-up volume, one that brings interdisciplinary analysis to focus specifically on dispute settlement in the WTO.

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Banking on Basel: The Future of International Financial Regulation. By Daniel K. Tarullo. Washington, DC: Peterson Institute for International Economics, 2008. Pp. xiii, 310. Index. \$26.95.

The global financial crisis has attracted considerable attention to the failure of domestic and international regulation to prevent the accumulation of excessive risks in banks and other financial institutions. In *Banking on Basel*, Daniel K. Tarullo, a Georgetown University law professor who was recently appointed to the Federal Reserve Board of Governors, provides a timely, careful, and sharply critical account of a pivotal international financial regulatory regime, namely the harmonized bank capital standards developed by the Basel Committee on Banking Supervision (Committee). While Tarullo provides an overview of the original 1988 Basel Accord (Basel I),¹ the book's

emphasis is on its replacement, Basel II,² an ambitious effort to develop regulatory capital requirements premised on reliance on banks' own internal credit risk assessments. Beyond its sheer technical complexity, the new accord is remarkable because—unlike most international financial regulatory efforts—it was not based on existing national approaches but designed “more or less from scratch through international negotiations” (p. 195).

Basel II's protracted and intensely contentious development began with the Committee's initial proposal in 1999, and continued well beyond the publication of the revised accord in 2004, as numerous tests, revisions, and updates accumulated.³ Tarullo's assessment of the result is unsparing: “Basel II's detailed rules for capital regulation,” he concludes, “are not an appropriate basis for an international arrangement among banking supervisors” (p. 5). As a domestic regulatory framework, Basel II suffers from “manifold conceptual and practical problems” (p. 6) that seriously compromise its effectiveness; as an international arrangement, its “infirmities” will be “multiplied as more countries adopt it, while the difficulties in effective monitoring of its implementation will limit any benefits arising from common adoption of the regulatory model” (p. 7). These stark conclusions are grounded in a detailed account of the political economy of the transition to Basel II and an assessment of the substantive merits of the new accord, both as a domestic regulatory model and as an international agreement.

In chapter 2, Tarullo begins his analysis by introducing the economic rationale for imposing regulatory capital requirements on banks, underscoring their increasing centrality to safety and soundness supervision as other regulatory restrictions on bank activities faded. Then, in chapters 3 and 4, he describes the origins and development of international capital standards, with emphasis on the fundamental shift in approach from Basel I to

¹ Basel Committee on Banking Supervision, International Convergence of Capital Measurement and Capital Standards (Basel Accord), July 1988 [hereinafter Basel I], available at <http://www.bis.org/publ/bcbs04a.htm>.

² Basel Committee on Banking Supervision, International Convergence of Capital Measurement and Capital Standards: A Revised Framework, June 2004 [hereinafter Basel II], available at <http://www.bis.org/publ/bcbsca.htm>.

³ *Id.*

Basel II. Basel I was a relatively simple framework, driven by the United States and the United Kingdom's desire to minimize the competitive disadvantage that would arise if they unilaterally adopted capital standards in the wake of the 1980s savings-and-loan and sovereign lending crises. In 30 pages, bank supervisors from 12 major financial markets agreed to impose a uniform minimum capital requirement of 8 percent of a bank's risk-weighted assets.⁴ Tarullo points to substantial evidence showing that, in the years immediately following its adoption, Basel I increased bank capital in adopting countries. Over time, Basel I expanded well beyond the Committee members as international financial institutions and market participants adopted it as a benchmark for domestic banking regulation around the world. While Tarullo concludes that the accord was, on the whole, effectively implemented, significant difficulties nevertheless arose. First, its rudimentary risk-weighting formula lagged behind modern risk management practices, encouraged regulatory arbitrage, and was feared to have procyclical macroeconomic effects. Second, the substantial discretion that Basel I left to national supervisors, as well as the lack of reliable monitoring, raised concerns that national authorities were stretching the rules to favor their banks. These concerns centered mostly—but not exclusively—on Japan, where regulators permitted various accounting and regulatory practices that overstated the capital position of their banks during the 1990s (pp. 69–72).

The first category of difficulties—the technical problems with Basel I and especially its per-

ceived obsolescence as quantitative risk management techniques became ever more sophisticated—increasingly motivated demand for a revised accord. In the United States, the calls for reform originated with the banks themselves and the Federal Reserve. Tarullo argues that, as the revision effort began, the nature of its momentum differed substantially from that behind Basel I: “Unlike prior major Basel Committee initiatives, this one was not impelled by a crisis” (p. 90) and “began without any clear proposal from any country” (p. 100). Instead, it was driven in great measure by the objectives of the largest international banks, which favored a revised approach that would allow them to base their regulatory capital requirements on their own internal risk measurements—a preference that “almost certainly rested on the expectation that their required capital levels would decline” (p. 101). Indeed, after a poorly received initial proposal that did not incorporate internal risk assessments, the Basel Committee adopted an “internal ratings based” (IRB) approach, which was meant to apply to the largest international banks and became the cornerstone of the revised accord.⁵

Tarullo traces the fate of the proposed framework through successive rounds of drafting and negotiations, describing political resistance by smaller banks that feared that IRB approaches would give large international banks a competitive advantage; bank-driven efforts to carve out more favorable risk formulae for credit card exposures and residential mortgages; and a high-level German political effort to lower capital requirements for loans to small and medium-size businesses.

⁴ Very generally, each asset held by a bank would be assigned a specific risk weight based on its classification under the accord. For instance, most commercial loans were assigned a 100% weight; most residential mortgage loans, 50%; and debt of Organisation for Economic Co-operation and Development (OECD) sovereigns, 0%. For each asset, banks would have to maintain capital equal to at least 8% of the risk-weighted value of the loan, i.e., its principal amount times the appropriate risk weight. Basel I also included a provision for assigning risk weights to contingent and other off-balance sheet liabilities (such as guarantees), and was amended in 1996 to institute capital requirements in respect of market risk related to financial instruments in the “trading book.”

⁵ More specifically, Basel II incorporates two “internal ratings based” (IRB) approaches. The “advanced” version (A-IRB), intended to apply to the largest and most sophisticated banks, allows banks to determine internally more of the statistical risk indicators that serve as inputs for the regulatory capital formula than the “standard” IRB approach. Importantly, in both versions, the actual capital requirement is not determined directly by the banks but by processing these internally derived inputs through the formula prescribed by the accord. Basel II also includes a “standardized” approach intended for smaller banks. That approach is essentially a revised version of the Basel I methodology that attempts to produce more precise risk weightings by relying on credit agency ratings.

The result was the release in 2004 of a dense 239-page document in which, as Tarullo notes with considerable understatement, “the legacy of years of compromise and adjustment is conspicuous” (p. 123). Even after its release, Basel II entered a process of continuous revision as quantitative studies to predict the new accord’s impact on capital levels produced widely inconsistent results, other implementation issues emerged, and “efforts of large US banks shifted to resisting the various safeguards proposed by the banking agencies to guard against significant capital declines once Basel II is implemented” (p. 149). The implementation of Basel II within the United States also led to a protracted struggle among the country’s banking regulators, Congress, and the banks, culminating in a series of complex compromises on the scope and timing of the implementing rules. In Tarullo’s view, “the important but abstract general interest in effective and efficient banking regulation was subordinated at key moments in the negotiations by commercial and bureaucratic interests” (p. 7).

In chapters 5 and 6, Tarullo turns to an assessment of the merits of Basel II as a domestic regulatory model and as an international arrangement. The details of his critique of the revised accord from a domestic perspective are beyond the scope of this review; suffice it to say that he raises significant questions about the reliability of the statistical credit risk models upon which Basel II rests, as well as the apparent inability of the Committee to predict how capital levels would change as a result of its adoption. Most striking, however, are the implementation and monitoring concerns raised by a system in which regulators, instead of prescribing a simple formula for capital requirements, are expected to supervise the banks’ internal process of credit risk assessment. While, in this new system, oversight of the construction and use by banks of their statistical credit risk models is crucial, it is unclear that regulators can build and retain the necessary technical expertise to monitor this process effectively on a large scale. The process, moreover, is fraught with difficulties and potential conflicts given the complexity of the accord and of the finance theory behind the banks’ models, the limitations of the available data, and

the incentives for banks to manipulate the calculations to lower their capital requirements. In addition to making the banks less accountable to regulators, Tarullo argues, Basel II may make the regulators themselves less accountable domestically and internationally.

This last point is crucial to Tarullo’s critique of Basel II as an international agreement. As noted above, a significant concern about Basel I was that its substantial scope for national discretion and lack of international monitoring left national regulators free to stretch the rules to favor their banks. Basel II, in its near-obsessive attempt to remedy the technical deficiencies of Basel I, likely worsens these problems. “[T]he extent of national discretion and the opaque quality of the IRB calculations,” Tarullo tells us, “breed countless opportunities for the exercise of regulatory discretion in pursuit of national competitive advantage, as well as for sound prudential reasons” (p. 213). While the more complex and sophisticated risk-measurement formulae may be a sensible trade-off in the context of domestic banking regulation, one may wonder what is left of the rationale for an *international* regime once the objectives of international financial stability and competitive equality hold so little weight. Tarullo also assesses some alternative rationales—such as reducing compliance costs, facilitating the cooperative supervision of international banks, and providing a model for banking reform in developing countries—but finds them unconvincing (pp. 214–23). He concludes that “it seems most likely that the substantive and international institutional drawbacks of Basel II will be mutually reinforcing” (p. 224).

Tarullo’s comprehensive account of Basel II is surprisingly clear and penetrating given the staggering complexity of the new accord and is essential reading for anyone interested in international financial regulation. His argument, however, has broader implications for contemporary debates on transnational regulatory networks, global administrative law, and international institutional design.

First, and most significantly, Tarullo’s unsparring critique of the Basel II process and its outcomes is at odds with the largely optimistic accounts of

governance through networks that dominate academic thought on international regulation. Anne-Marie Slaughter, among others, has argued that such networks can “solve the globalization paradox” by “expanding our global governance capacity without centralizing policy-making power.”⁶ The Basel capital standards may be the crown jewel of network governance: a detailed regime of uniform standards developed by the some of the most independent regulators—central bankers and bank regulators—in a prestigious and powerful network. In stark contrast with this perspective, Tarullo underlines the intensely contentious nature of the Basel Committee’s negotiations, the instrumental role of banks in the process, and the flaws of the outcome. His conclusions may call for reconsideration of the ideal of detached, expert-led international rulemaking. At the same time, he also points to a problematic divide between the global governance literature and specialized banking scholarship by noting that, throughout the Basel II process, “[m]any academics from across the ideological spectrum thought the entire enterprise misguided as a matter of sound regulatory policy” (pp. 13–14).

Second, the deficiencies of Basel II also raise important questions on the advisability of transposing administrative law processes to strengthen the accountability of transnational regulatory networks. As Tarullo relates, Basel II went much further than Basel I—or, for that matter, any prior transnational network initiative—in opening successive proposals to a “notice and comment” procedure, processing hundreds of comments, and making significant changes as a result of external input (pp. 97–122). In a recent article, Michael Barr and Geoffrey Miller praised the Committee’s approach, arguing that it “could be a model for international rule making with greater account-

ability and legitimacy.”⁷ However, in Tarullo’s account, Basel II was a largely rudderless process where the objectives of large international banks prevailed over sound regulatory policy. In addition, the slow and cumbersome bargaining and rulemaking involved in developing such a complex framework at the international level appear to undermine the usual rationales—namely ease of adoption, speed, and flexibility—for preferring “soft law” instruments over treaties.⁸ On the contrary, the enormous inertia of Basel II makes it likely to endure, for better or worse, as the cornerstone of international banking policy despite its serious flaws.

Finally, despite the book’s resolutely practical and policy-oriented approach, it shows the way towards a more promising analysis of international regulation. Tarullo’s first contribution is a simple but important conceptual step: separating the questions of whether Basel II is good *domestic* policy and good *international* policy. This step is crucial because it recognizes that international regulation rests on rationales and poses challenges that are intrinsically distinct from those of domestic regulation. Once the distinction is made, the difficulties inherent in developing international standards become apparent. For instance, features that in a domestic context would optimize a regulatory regime may create or exacerbate monitoring and enforcement problems that compromise its viability in an international setting. In the case of Basel II, while developing a complex credit risk measurement system that better aligns with modern risk management techniques was arguably desirable in the abstract, that objective may well be at odds with that of producing a manageable framework for international cooperation. Even more fundamentally, as Tarullo points out, there is also considerable theoretical uncertainty about what

⁶ ANNE-MARIE SLAUGHTER, A NEW WORLD ORDER 167 (2004); see also Kal Raustiala, *The Architecture of International Cooperation: Transgovernmental Networks and the Future of International Law*, 43 VA. J. INT’L L. 1, 51 (2002). For a critical perspective on regulatory networks, see Pierre-Hugues Verdier, *Transnational Regulatory Networks and Their Limits*, 34 YALE J. INT’L L. 113 (2009).

⁷ Michael S. Barr & Geoffrey P. Miller, *Global Administrative Law: The View from Basel*, 17 EUR. J. INT’L L. 15, 17 (2006).

⁸ See, e.g., Kenneth W. Abbott & Duncan Snidal, *Hard and Soft Law in International Governance*, in LEGALIZATION AND WORLD POLITICS 37 (Judith L. Goldstein et al. eds., 2001); Charles Lipson, *Why Are Some International Agreements Informal?* 45 INT’L ORG. 495 (1991).

level of capital is optimal, whether capital adequacy standards should be as central to bank regulation as they now are, and even whether regulatory requirements actually affect bank behavior (pp. 23–27, 35–42, 141–44). Given such uncertainty, adding a layer of complexity by attempting to develop truly new rules in international negotiations was bound to create serious difficulties. Another insightful—although underdeveloped—contribution is Tarullo's characterization of the negotiation of international regulatory standards as a hybrid between the domestic regulatory process and trade negotiations, in which governments compete for competitive advantage (p. 52).

Despite these great strengths, the book has some limitations. Given the potency of Tarullo's critique of Basel II, the modesty of his recommendations is somewhat startling. "While a case can be made that the IRB approach would best have been abandoned some years ago," he tells us, "that is not a realistic starting point for policy recommendations at present" (p. 12). In chapter 7, he reviews several potential alternatives to Basel II's IRB regime and finds that none of the various proposals—retaining Basel I's standardized approach, requiring banks to issue subordinated debt or precommit to specific levels of capital, or transforming the Basel Committee into a supranational bank regulatory agency—could function on its own as a complete alternative. He therefore recommends in chapter 8 limited reforms that include redefining capital to reduce national discretion, supplementing the IRB approach with a simple leverage ratio, requiring banks to issue subordinated debt to enhance market discipline, shifting the emphasis from rules to principles, and strengthening the monitoring role of the Committee through a roving "inspection unit" (pp. 277–79). Most of these recommendations essentially consolidate and refine alternatives proposed by others and frame them as complements to Basel II. One also wonders, if Tarullo's recommendation for an international leverage ratio is adopted and becomes the effectively binding constraint on banks, what benefits the painstaking development of the IRB approach actually yielded. These limitations, however, do not detract from the book's significance as a critical analysis of Basel II.

Most worrisome perhaps are Tarullo's reflections on the implications of the financial crisis for Basel II. While he is careful to note that the revised framework had not yet been implemented at the relevant times, he points out that it reflects—and perhaps exacerbates—many problematic features of precrisis regulation, such as reliance on capital requirements as a regulatory tool, faith in statistical risk models and external credit agency ratings, and favorable treatment of residential mortgages. Given the book's publication in 2008, the reader cannot benefit from Tarullo's assessment of the revisions adopted in 2009, some of which attempt to address these problems and other recommendations made in the book. The broader financial reforms currently under consideration in the United States and abroad are also likely to alter significantly the regulatory environment for banks. Nevertheless, Tarullo's portrayal of the domestic and international bank regulatory process hardly inspires confidence. "While the aftermath of the subprime crisis may give an advantage to prudential considerations," he warns, "experience suggests that this weight will rather quickly be removed from the scales once the crisis has passed" (p. 137).

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BRIEFER NOTICE

International Law: A Russian Introduction. By V. I. Kuznetsov and B. R. Tuzmukamedov. Edited and translated by William E. Butler. Utrecht: Eleven International Publishing, 2009. Pp. xxxiii, 720. Index. \$142, €89.*

International Law: A Russian Introduction is a superb English translation by William Butler of the original Russian-language version of this book, which he reviewed three years ago in this *Journal*.¹ In his review, which I highly recommend, Butler traced the history of international law texts in the

* Sold and distributed in the United States and Canada by International Specialized Book Services, Portland, OR.

¹ 101 AJIL 917 (2007).