Making Sense of the Role of External Ratings in Basel II

The intertemporal and interregional analysis of the regulatory use of credit ratings has provided empirical support for the theoretical framework proposed in Chapter 3. In a next step, I examine more closely the decision to include the option of external ratings-based credit-risk assessment into the Basel II provisions. This should provide a more accurate picture of the causal factors underlying decisions for or against the use of credit ratings in regulation. In particular, it should serve to retrace and, if need be, specify the causal mechanism connecting the independent variable and the dependent variable.

The Basel II Accord highlights the increased role that nonstate actors (both credit institutions and, which is particularly relevant for this book, credit rating agencies) play in the design and implementation of rules governing global financial markets (Speyer 2006: 101). On the following pages, I take a closer look at commonalities and differences in the positions of the US negotiators (i.e. representatives from the Board of Governors of the Federal Reserve System, the Federal Reserve Bank of New York, OCC, FDIC and OTS) and the German negotiators (German Central Bank and BaFin) in the Basel II negotiations (1998–2004).¹ I examine to what extent the national positions of the US and Germany in the Basel II process and the final provisions in the Basel II Accord correspond to the causal arguments and hypotheses of the theoretical framework developed in this book.
Commonalities and differences in the positions of Basel II negotiators

As outlined in Chapter 2, Basel II was supposed to address regulatory issues left open by Basel I, to correct wrong incentives set by uniform capital requirements which did not take into account the creditworthiness of borrowers, and, more broadly speaking, to adapt banking supervision procedures to changed conditions in financial markets. There was broad agreement in the BCBS on these general objectives, and both US and German representatives were in favor of a revision of the Basel I standards (Becker 2007: 82). In 1999, the US Department of the Treasury stressed it was ‘very important that the Basel Committee work quickly to complete its updating of the Basel Capital Accord, by expanding the number of credit-risk categories and revising the current all-or-nothing system for classifying loans to sovereign borrowers’ (US Department of the Treasury, quoted in Becker 2007: 82). The German Federal Bank agreed on the need for an overhaul of banking supervision procedures and a revision of capital requirements with a view to making them more risk-sensitive.

Furthermore, there was a consensus among negotiators on some major necessities and the general regulatory approach to be taken in banking supervision. Negotiators saw a need for closer alignment of the regulatory framework and market practice in order to promote market stability and efficiency. For that purpose, more flexibility and risk-sensitivity in regulation and thus more sophisticated rules were necessary (Speyer 2006: 111–12; Tsingou 2008: 58–60).

In 2000, the then Federal Reserve Board Governor, Laurence Meyer, aptly summarized the US preference for designing supervisory solutions which are in tune with markets:

[W]e have limited public policy choices for large and complex organisations. Choice 1: we can accept systemic risk as a cost of having large, global organisations in the marketplace. Choice 2: in order to limit systemic risk, we can adopt very detailed regulation and supervision programmes that include a growing list of prohibitions. Choice 3: we can rely more on market discipline to supplement capital reforms and can maintain a level of supervision similar to the one we have today. Given the choices, we simply must try market discipline. (Meyer, quoted in Tsingou 2008: 59)