

**Compliance with International Regulatory
Regimes: The Basel Capital Adequacy
Accord in Japan, South Korea, and Taiwan,
1988-2003**

Hyoung-kyu Chey

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Abstract

The IPE literature on compliance has presented three theoretically competing mechanisms to induce compliance with international regulatory regimes: externality-based, market, and domestic compliance mechanisms. However, most studies on compliance have limited their analytic focus to formal compliance with explicit provisions of regimes, neglecting the question as to whether formal compliance enhances regime effectiveness, which is the fundamental issue of compliance. Yet, although national authorities implement an international regulatory regime, they frequently manipulate the implementation to help regulatory targets formally comply with its explicit provisions but still allow them, in practice, to defect from its objectives. This study introduces the concepts of *cosmetic compliance* and *comprehensive compliance*, and it analyses the effectiveness of the three compliance mechanisms in ensuring comprehensive compliance by addressing compliance with a momentous international financial regulatory regime, the 1988 Basel Capital Adequacy Accord, in three important Asian countries, Japan, South Korea, and Taiwan, from 1988 to 2003.

All three countries were formally in compliance with the regime throughout most of the period. However, Japan's compliance was consistently cosmetic, while Korea and Taiwan also complied cosmetically during much of the period. A high degree of comprehensive compliance occurred only in Taiwan during the early 1990s and in Korea during the late 1990s and early 2000s. All three compliance mechanisms contributed to formal compliance. However, the externality-based compliance mechanism and the market compliance mechanism were not effective in ensuring comprehensive compliance. The operation of the domestic compliance mechanism was necessary for comprehensive compliance; yet, its effectiveness relied on the capacity of national authorities to implement it. As a result, the actual outcome of the operation of the domestic compliance mechanism was affected by domestic factors, in particular, the capacity to deal with formal compliance failures by regulatory targets, the domestic distributional effects of compliance, and the independence of the regulatory authority.

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Abbreviations

| | |
|-------------|------------------------------------------------|
| BCBS | Basel Committee on Banking Supervision |
| BIS | Bank for International Settlements |
| BoJ | Bank of Japan |
| BoK | Bank of Korea |
| BoMA | Bureau of Monetary Affairs (Taiwan) |
| CAR | Capital adequacy ratio |
| CBC | Central Bank of China (Taiwan) |
| CCPC | Cooperative Credit Purchasing Company (Japan) |
| CDIC | Central Deposit Insurance Corporation (Taiwan) |
| CRA | Credit rating agency |
| DICJ | Deposit Insurance Corporation of Japan |
| DPP | Democratic Progressive Party (Taiwan) |
| DTA | Deferred tax asset |
| EC | European Community |
| EPA | Economic Planning Agency (Japan) |
| EPB | Economic Planning Board (Korea) |
| FBAJ | Federation of Bankers Associations of Japan |
| FFH | First Financial Holdings (Taiwan) |
| FLC | Forward Looking Criteria |
| FPC | Financial Policy Council (Korea) |
| FRC | Financial Reconstruction Commission (Japan) |
| FRF | Financial Restructuring Fund (Taiwan) |
| FSA | Financial Services Agency (Japan) |
| FSC | Financial Supervisory Commission (Korea) |
| FSF | Financial Stability Forum |
| FSS | Financial Supervisory Service (Korea) |
| G10 | Group of Ten |
| G7 | Group of Seven |
| GRK | Government of Republic of Korea |
| IMF | International Monetary Fund |
| IPE | International political economy |

| | |
|------------------|--------------------------------------------------------|
| IR | International relations |
| JBA | Japanese Bankers Association |
| JCIF | Japan Center for International Finance |
| JSBRI | Japan Small Business Research Institute |
| KCCI | Korean Chamber of Commerce and Industry |
| KDB | Korea Development Bank |
| KDIC | Korea Deposit Insurance Corporation |
| KEB | Korea Exchange Bank |
| KFB | Korea Federation of Banks |
| KMT | Kuomintang (Taiwan) |
| LDP | Liberal Democratic Party (Japan) |
| LIBOR | London Interbank Offered Rate |
| MFJ | Ministry of Finance of Japan |
| MFK | Ministry of Finance of Korea |
| MFT | Ministry of Finance of Taiwan |
| MoFE | Ministry of Finance and Economy (Korea) |
| NARK | National Assembly of Republic of Korea |
| NPL | Non-performing loan |
| OBS | Office of Bank Supervision (Korea) |
| OECD | Organisation for Economic Co-operation and Development |
| PCA | Prompt Corrective Action |
| PFOC | Public Funds Operation Committee (Korea) |
| PFR | Programme for Financial Revival (Japan) |
| RML | Risk Management Loan (Japan) |
| S&P's | Standard and Poor's |
| SME | Small- and medium-sized enterprise |
| TRC | Taiwan Ratings Corporation |

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CHAPTER 1

Introduction

This thesis addresses compliance with a single international regulatory regime, the Basel Capital Adequacy Accord of 1988 (hereafter “the Basel Accord” or “the BIS standard”).¹ I compare compliance across three important Asian countries: Japan, South Korea (hereafter Korea), and Taiwan during the period of 1988 to 2003. The BIS standard has been *the* international standard since its establishment, and has been adopted in some form by more than hundred countries (BCBS 2004a). As a result, the BIS standard has achieved symbolic significance for regime compliance. Indeed, a vast number of international relations (IR) studies have researched the establishment of, international convergence on, or global compliance with the Basel Accord.² However, the intention of most of these studies is to explain how this event in the history of international economic relations was achieved, without questioning the nature of compliance with the BIS standard. In this study, I provide an in-depth analysis of this issue, drawing attention to the need to rethink the significance of global compliance.

Over the past fifty years, the number and range of international regimes have expanded rapidly with the development of rules governing economic, social, communications, environmental, and human rights behaviour.³ This mushrooming of international regimes has led IR scholars to devote a good deal of theoretical and empirical study to explaining why states have entered into this vast web of agreements, therefore sacrificing a degree of legal sovereignty (Simmons 1998: 75-76).⁴ In recent years, studies of international regimes have made significant progress by going beyond the traditional major theme of regime formation and change to address issues of regime

¹ BIS is the abbreviation for the Bank for International Settlements. In this study, the term *Basel Accord* is used when referring to the Basel Capital Adequacy Accord as an international agreement, while the term *BIS standard* is employed when referring to it as a regulatory standard.

² See, for example, Ho (2002), Kapstein (1989;1992;1994), Oatley and Nabors (1998), Reinicke (1995), Simmons (1998), Singer (2004), Tamura (2003b), and Tobin (1991).

³ For example, by September 2005, the number of multilateral treaties under the auspices of the United Nations reached more than five hundreds (see United Nations 2005).

⁴ Dominant IR views generally argue that governments make commitments to international regimes in order to secure policy changes from others or to gain influence over other states' policies (Simmons 1998: 76).

compliance.⁵ In addition, scholars have begun to tackle the compliance not only of governments but also of businesses, which are the real targets of a growing number of regulatory regimes in areas such as accounting, the environment, finance, health, and labour (Börzel 2000: 2-3; Chayes and Chayes 1993: 193).⁶

However, despite the burgeoning interest in compliance issues, the concept of compliance applied in most studies is so narrow that these studies have difficulty linking their analysis to the issue of regime effectiveness, which is the fundamental question of compliance. Much research limits its analytic focus to formal compliance with *explicit* rules prescribed in international regimes, while defining noncompliance strictly as behaviour in breach of them.⁷ Yet, in certain circumstances, national authorities do implement an international regulatory regime, but they manipulate the implementation in a way that helps domestic actors to formally comply with its explicit provisions but still allows them, in practice, to defect its objectives. In this situation, both the national authorities and the regulatory targets are in formal compliance, but this compliance is only cosmetic. Cosmetic compliance can be a menace to the effectiveness of international regimes, because they cannot solve the problems they were established to solve. Nevertheless, cosmetic compliance is vastly underexplored.

A growing number of studies suggest that cosmetic compliance is *not* an extraordinary problem, but rather a common phenomenon in various international regulatory regimes. A recent report by the International Monetary Fund (IMF) (2004) indicates that cosmetic compliance is prevalent in financial regulatory regimes. The report analyses the implementation of three international financial standards in the banking, insurance, and securities sectors in thirty-six IMF member (consisting of ten industrialised countries, twelve emerging market countries, and fourteen developing countries from Africa, Asia, Europe, the Middle East, and the Western Hemisphere). The report argues that although the majority of countries formally implemented those standards, significant weaknesses existed in actual regulatory practice, reducing the effectiveness of regulation.⁸ In another study, Edith Brown Weiss and Harold K. Jacobson (1998) demonstrate that the compliance with five environmental regimes in

⁵ For a review of the literature on regime development and change, see Haggard and Simmons (1987) and Hasenclever, Mayer, and Rittberger (1997).

⁶ See, for example, Mitchell (1994) and Kollman and Parakash (2001).

⁷ A notable exception that addresses compliance in a broader sense is Weiss and Jacobson (1998).

⁸ Andrew Walter (2003) also argues that even after the 1997 Asian financial crisis, a number of the crisis-hit countries failed to implement the BIS standard strictly for political economy reasons, as will this thesis argue.

the United States, the European Union, Japan, the Russian Federation, Hungary, China, India, Cameroon, and Brazil was frequently weak. Cosmetic compliance is a serious challenge to the effectiveness of a range of international regulatory regimes.

What determines compliance with international regulatory regimes? Why does cosmetic compliance occur? To answer these questions, this study analyses the effectiveness of three main compliance mechanisms presented by existing literature—compliance pressures from foreign countries, from the markets, and from domestic actors—, and examines the factors influencing the operation of these compliance mechanisms. I argue that although external compliance pressures may induce formal compliance with an international regulatory regime, they are less effective in restricting cosmetic compliance. National regulatory authorities can manipulate the implementation of international regimes in their jurisdictions. The willingness and the capacity of national regulatory authorities to comply are, accordingly, critical for the compliance that enhances regime effectiveness. Second, even if national regulatory authorities are willing to implement an international regulatory regime in earnest, their implementation capacity and, in turn, the actual compliance outcomes, are affected by domestic factors. In particular, I argue that the likelihood of compliance failure—including cosmetic compliance—increases when governments lack the capacity to deal with formal compliance failures by the regulatory targets, when compliance costs are diffused from regulatory targets to politically important sectors, or when the independence of the regulatory authorities is low.

1.1 Central concepts

An essential first step in the analysis of compliance with an international regulatory regime is to possess a clear definition of compliance. In this study, compliance is defined in relation to regime effectiveness. Accordingly, the concept of regime effectiveness should be firmly established in advance. In addition, this research analyses compliance with the BIS standard by examining how it was implemented, and therefore the analysis should have a clear definition of implementation. Before proceeding further, I define these three concepts: regime effectiveness, compliance, and implementation.

Regime effectiveness. The effectiveness of an international regulatory regime can be viewed from diverse angles. Oran R. Young (1994: 142-152) articulates six distinct dimensions of regime effectiveness: problem-solving effectiveness, goal-attainment

effectiveness, behavioural effectiveness, process effectiveness, constitutive effectiveness, and evaluative effectiveness. Problem-solving effectiveness is a measure of the extent to which an international regime operates to solve the problems that it was established to solve. Goal-attainment effectiveness asks whether an international regime's (stated or unstated) goals are achieved. Behaviour effectiveness refers to the effect of an international regime on the behaviour of the national authorities that established it or of the regulatory targets under their jurisdiction. Process effectiveness refers to the extent to which the provisions of an international regime are incorporated into the member countries' domestic legal and political system, as well as the extent to which those subject to the regime's rules actually comply with the requirements. Constitutive effectiveness asks whether an international regime gives rise to new social practices. Finally, evaluative effectiveness concerns the extent to which an international regime produces the desired results in a cost-effective manner.

In this study, which is based on Young's first dimension of regime effectiveness, the effectiveness of an international regulatory regime is defined as the extent to which it attains its fundamental objectives.⁹ Therefore, the BIS-standard regime is considered effective when it has achieved the objectives of the Basel Accord. It may not always be easy to measure regime effectiveness of this kind; the lack of necessary economic data may hinder the evaluation of an international regulatory regime's effectiveness. However, this measurement problem may be solved to some extent by examining observable effects of an international regulatory regime (that is, whether its members adjust their behaviour to comply with the ultimate objectives) (see Keohane, et al. 1994: 7-8; Miles, et al. 2001: 4-13).¹⁰

It is worth noting that the concept of regime effectiveness is distinguished from that of regime consequences, which refer to the more general impacts of international regimes, whether intended or not, issue-specific or general. An international regime may affect not only the behaviour of those regulated by it, but also the distribution of capacities, the cognition of different factors, or the values and interests of participants and non-participants (Zürn 1998: 632). These factors may be influenced by the regime in ways that enhance its effectiveness. However, the operation of the regime may also give rise to factors that reduce its effectiveness. Therefore, while the consequences of an

⁹ This definition of regime effectiveness is commonly employed in environmental studies. See, for example, Jacobson and Weiss (1998b: 5), Miles, et al. (2001: 4-13), and Victor, Raustiala, and Skolnikoff (1998: 6).

¹⁰ The problem-solving effectiveness of an international regime may require its effectiveness in the other five dimensions.

international regime affect its effectiveness, the relationship between the two can be either positive or negative.

Compliance: cosmetic, and comprehensive. Most studies of compliance with international regimes define compliance in line with Young's (1979: 3) conceptualisation of compliance in his groundbreaking research on compliance with international public authority. He suggests that compliance occurs "when the actual behaviour of a given subject conforms to prescribed behaviour," and, inversely, noncompliance or violation refers to the state in which "actual behaviour departs significantly from prescribed behaviour." In other words, this traditional definition of compliance/noncompliance narrowly focuses on behavioural conformity to explicit provisions of international regimes.

This narrow definition of compliance seems useful for empirical studies, as it may increase the operational clarity of the concept by distinguishing compliance from noncompliance in clear and replicable ways (Mitchell 1994: 429). However, restricting a study to formal compliance with the explicit provisions of international regimes may fail to address the effectiveness of the regime. Given that the provisions of an international regime are generally constructed in ways to achieve its ultimate objectives, a high degree of formal compliance may typically be positively related with the effectiveness of the regime. Yet, where an international regime is inadequately designed, a high level of compliance can be easily attained without a substantive impact on the problems the regime was established to solve (Jacobson and Weiss 1998b: 5; Simmons 1998: 77-78). Alternatively, international regimes where formal compliance levels are high may explicitly require a low degree of behavioural change (see Downs, et al. 1996: 382-387). The usefulness of a narrow definition of compliance becomes more doubtful when addressing the effectiveness of a regulatory regime where cosmetic compliance occurs.

The term *cosmetic compliance* refers to the state in which the behaviour of national authorities and regulatory targets is formally in compliance with the explicit provisions of the international regime of concern (in other words, national authorities incorporate them into the domestic regulations and the regulatory targets are in compliance with the provisions), but the authorities manipulate the implementation of the regime to allow the regulatory targets to defect from its objectives. In this situation, the formal compliance of the national authorities and the regulatory targets does not make an actual contribution to the regime's effectiveness. Cosmetic compliance may not be regarded as

noncompliance from a legal point of view. However, it can nullify the effectiveness of an international regulatory regime by hindering it from solving the problem it was formed to solve. Thus, cosmetic compliance should be considered a form of noncompliance in terms of regime effectiveness.

The term *comprehensive compliance* refers to the state in which the behaviour of national authorities and regulatory targets is in line with not only the formal provisions but also with the ultimate objectives of the international regulatory regime of concern.¹¹ Comprehensive compliance augments the effectiveness of the regime by facilitating the achievement of its objectives. The distinction between these two different types of compliance makes it easier to evaluate the significance of compliance in terms of regime effectiveness.

Implementation. In an influential study of domestic policy, Daniel A. Mazmanian and Paul A. Sabatier (1983: 4) conceptualised (policy) implementation as “those events and activities that occur after the issuing of authoritative public policy directives, which include the effort to administer and the substantive impacts on people and events.” This study adopts this common-sense definition of implementation, but refines it to some extent to increase its adaptability for international regulatory regimes. In this study, the implementation of an international regulatory regime refers to activities or measures of national authorities through which the provisions of the regime are put into practice. This concept of implementation highlights three salient points.

Firstly, the implementation of international regulatory regimes is not necessarily positively related to their effectiveness. Implementation is simply a process through which international regulatory regimes are put into practice. It may be carried out in a way that strengthens comprehensive compliance, but also may be a way to induce cosmetic compliance. Accordingly, the nature of compliance with an international regulatory regime is influenced by the attitude of those who implement it towards its objectives and provisions.¹² Secondly, the concept of implementation brings the intended behaviour of the actors into focus, while compliance can occur without implementation. When the rules prescribed in an international regulatory regime match

¹¹ The definition of comprehensive compliance is similar to the concept of “substantial compliance”, which was used by Jacobson and Weiss (1998b: 4)

¹² Andrew Gouldson and Joseph Murphy (1998: 15-16) point out that agencies and actors who are responsible for implementation can exercise discretion in such a way as that the key principles and objectives of a policy are interpreted, prioritised and delivered, thereby determining the nature of policy as practice.

the existing behaviour of the regulatory targets, implementation is not necessary and compliance is automatic (Raustiala and Slaughter 2002: 539). In other words, to use Arild Underdal's (1998: 6) terms, "compliance by default" does not require implementation.¹³ Compliance can also occur due to uncontrollable external events.¹⁴ Therefore, compliance is not always the causal outcome of implementation. Finally, this definition of implementation confines it to activities carried out by national authorities, which is a common usage of implementation in literature.¹⁵ Although activities or measures that are employed by other actors—domestic or foreign—affect implementation, they are not regarded as implementation *per se*.

1.2 Theories of compliance

What determines compliance with international regulatory regimes? Literature on compliance is generally categorised into two schools of thought, which have been labelled the "management school" and the "enforcement school" since a seminar debate occurred between Abram Chayes and Antonia Handler Chayes (1993, 1995) and George W. Downs, David M. Rocke, and Peter N. Barsoom (1996) in the mid-1990s. These two schools are vividly differentiated by the compliance strategies they propose. The management school emphasises problem-solving approaches, such as the improvement of dispute resolution procedures, capacity building, or the development of transparent information systems, while the enforcement school stresses coercive measures against noncompliant states by other states.¹⁶ However, this simple categorisation of the literature does not fully capture the relevant literary contributions to compliance study, namely on harmonisation/convergence and on the effect of international institutions on state behaviour. In addition, management theorists do not pay much attention to the issue of why states comply, arguing that compliance with international agreements is

¹³ The level of compliance with international treaties in the area of tariffs or arms control is high because most treaties required states to make only modest departures from what they would have done in the absence of the treaties (Downs, et al. 1996: 380).

¹⁴ For example, the economic collapse of the Soviet Union caused its compliance with a number of environmental agreements (Raustiala and Slaughter 2002: 539).

¹⁵ See, for example, Jacobson and Weiss (1995), Simmons (1998), and Underdal (1998).

¹⁶ For the work from the management school, see Chayes and Chayes (1993), Chayes and Chayes (1995), and Chayes, Chayes, and Mitchell (1998). For the work from the enforcement school, see, Dorn and Fulton (1997), Downs, Rocke, and Barsoom (1996), and Oye (1986a). A few scholars argue that the compliance strategies proposed by the two schools are in practice complementary. See, for example, Tallberg (2002).

generally quite good;¹⁷ meanwhile, the enforcement approach tends to assume that international regimes are designed to solve collective action problems, even though there exist international regimes established for different purposes (see Botcheva and Martin 2001: 3). I review the body of compliance literature by categorising it into three broad perspectives—systemic, market-based, and domestic—according to the source of compliance pressure.

The systemic perspective

Systemic theorists conceive states as rational actors that behave only to further their own interests in the anarchic structure of the international system. States make compliance decisions based on cost/benefit calculations. Meanwhile, compliance/noncompliance of states may have an effect on other states' interests. Accordingly, states that will suffer from negative externalities generated by noncompliance by others may have the incentive to put pressure on them to comply. The systemic perspective argues that this compliance pressure from foreign states on other states may ensure their compliance by raising the costs of noncompliance. In this study, this compliance pressure is labelled the *externality-based compliance mechanism*.

States may voluntarily comply with international regimes without external compulsion if compliance increases their interests. For instance, in regimes whose nature is a coordination game, states have a common interest in avoiding a particular outcome. Such a regime may be difficult to establish when states disagree about the choice of preferred equilibrium. Yet, once established, compliance with the regime tends to be self-enforcing, because any state that departs from it would hurt only itself. One example of a coordination regime is the rule of the International Civil Aviation Organisation, which requires every flight control centre to have enough English-speaking staff on duty to direct pilots (Stein 1982: 313-315).

However, international regimes whose nature is a collaboration game face the problem of monitoring and compliance. In the collaboration game, which can be typically depicted by the Prisoners' Dilemma, actors have mixed motives: to cooperate, and to defect. Each actor prefers mutual cooperation (CC) to mutual defection (DD), but also successful cheating (DC) to mutual cooperation and mutual defection to victimisation by another's cheating (CD). Overall, each actor's preference ordering is:

¹⁷ Management theorists focus on finding factors that hinder compliance and how to improve it.

DC>CC>DD>CD. In short, even though the actors can gain from cooperation, they can gain even more from defection. Therefore, collaboration-game regimes are vulnerable to defection (Oye 1986b: 7-8; Stein 1982: 304-308, 312-313). For example, a state may increase its interests in an international trading regime when it exports to foreign markets but it closes its own markets to foreign countries. Likewise, in an international monetary regime, a state may strengthen its international competitiveness by devaluing its currency unilaterally (Gilpin 2001: 90). The prospect of compliance may become gloomier if states seek not only absolute gains but also relative gains (see Grieco 1988).¹⁸ In these circumstances, punishments exacted by states on others for noncompliance through a means such as tit-for-tat (see Axelrod 1984) may ensure compliance, as they raise the costs of noncompliance.¹⁹

According to Downs, Rocke, and Barsoom (1996: 382-387), the magnitude of enforcement needed to ensure compliance increases in collaboration-game regimes as what they call “depth of cooperation,” the extent to which an international regime requires states to depart from what they would have done in its absence, grows. They introduce a bilateral trade-game model, in which the temptation to cheat rises rapidly along with the cooperativeness of a treaty, while the treaty benefits rise less rapidly. The increase in the ratio of the benefit of defecting to that of cooperating suggests that increasingly severe punishment is necessary to prevent defection as the benefits of the treaty and corresponding restrictiveness of its requirements increase. Therefore, they argue that the punishment for noncompliance has to hurt defecting states to a point at least equal to that which could be gained by the violation.

Moreover, international regimes may not be always uniformly Pareto-superior to non-cooperative national policies (Gilpin 2001: 86; Simmons 2001: 591). Some international regimes may be established by the dominant state or by a limited group of powerful states in order to promote their own interests. Such a regime may be considered generally benign if a majority of states can benefit from compliance with the regime. However, some states may be reluctant to comply without compulsion, because their costs of compliance may exceed the benefits gained due to compliance (not because they may gain more from defection), while their noncompliance generates

¹⁸ While neoliberals emphasise absolute gains that states obtain from cooperation, realists focus on both absolute and relative gains. Duncan Snidal (1991) argues that relative gains impede cooperation in a special case of the two-state interaction, in which the actors have a high concern for relative gains and nearly disregard absolute gains, while the significance of relative gains is attenuated where there are more than two states or where states care about a mixture of absolute and relative gains.

¹⁹ The enforcement school is generally in line with this argument.

negative externalities for others. In such a situation, compliance of these states may be forced by other states that have an interest in their compliance. The control of money laundering may provide one example, although it is not a highly institutionalised regime. Some small states (for example, Switzerland, Liechtenstein, or Luxembourg) and some developing economies had a number of reasons not to adopt tight anti-money laundering regulations. Nevertheless, led by the United States (with Europe's eventual support), the Organisation for Economic Co-operation and Development (OECD) countries created the Financial Action Task Force in 1989; the task force pressured both its members and non-members to implement stricter controls over money laundering. As a result, a large number of countries, including almost all industrialised economies, agreed by the early 2000s that money laundering should be considered a crime (Simmons 2001: 605-609).

It is worth noting that both schools of systemic theorists, the realists and the neoliberals, emphasises the role of foreign states in ensuring compliance through pressure, despite the difference in their views of international regimes. Realists argue that international regimes are epiphenomena of the international power distribution. The dominant state in the international system establishes international regimes in accordance with its own interests, and, accordingly, it forces other states to comply with the regimes. The theory of hegemonic stability offers a classic example of the realist argument (see Gilpin 1981; Kindleberger 1973; Krasner 1976). On the other hand, neoliberals view international regimes as decentralised institutions that provide joint gains to the member states. They argue that international regimes can enhance the prospect of punishment of noncompliant states through retaliation based on reciprocity by other member states or through penalisation by third parties of those with bad reputations, by providing information about states' compliance or by linking issues to one another (in other words, by creating open-ended Prisoners' Dilemma) (Axelrod and Keohane 1986: 237-238, 249-250; Keohane 1984: 98-106, 1992: 178).²⁰ While realists and neoliberals disagree on the centrality of the source of compliance pressure, they do agree that compliance may be enhanced by pressure on states from other states that will suffer from the negative externalities of their noncompliance.

²⁰ Mitchell (1994) and Botcheva and Martin (2001: 11-12) argue that even within a single issue area an international regime with well-designed compliance systems can facilitate compliance.

The market-based perspective

The market-based perspective argues that market forces can facilitate compliance with international regulatory regimes that are *accepted* by the market. Rules established by an international regulatory regime may provide a focal point for market actors against which they can evaluate the competitiveness of the relevant regulatory targets. If market participants accept the rules as reliable, those who do not conform to them may be considered non-competitive by market participants and accordingly may be penalised. Market pressures to comply with the regime's rules can appear in diverse forms—for example, differentiated credit ratings, borrowing spreads, or asset allocations. The term *market compliance mechanism* in this study refers specifically to compliance pressure based on such competitive pressure from markets.

It should be noted that although the market-based perspective highlights competitive pressures from markets, it is not bound by the rigidity of the “race-to-the-bottom” thesis. The thesis claims that fierce competition generated by the globalisation of the world economy tends to produce a strong tendency towards regulatory laxity across countries.²¹ However, there are a number of studies to provide counterevidence to this thesis.²² Indeed, it is widely recognised that the optimal system for economic activities is not a regulation-free world, although there is little agreement on what is or would be optimal regulation.

The market compliance mechanism has attracted substantial attention from international financial institutions as a means to promote compliance with “international (or global) standards” or “best practices.” For instance, the Financial Stability Forum (FSF), which comprises key financial regulators and supervisors worldwide, has put significant emphasis on enhancing market incentives as a main strategy to foster the implementation of “the 12 key international standards for sound financial system,” which consist of Code of Good Practices on Transparency in Monetary and Financial Policies, Code of Good Practices on Fiscal Transparency, Special Data Dissemination Standard/General Data Dissemination System, Principles and Guidelines for Effective Insolvency and Creditor Rights System, Principles of Corporate Governance, International Accounting Standards, International Standards on Auditing, Core Principles for Systemically Important Payment Systems, The Forty Recommendations

²¹ See, for example, McKenzie and Lee (1991) and Chan and Ross (2003)

²² See, for example, Basinger and Hallerberg (2004), Busse (2004), Glyn (2004) and Prakash and Kollman (2003).

of the Financial Action Task Force on Money Laundering, Core Principles for Effective Banking Supervision, Objectives and Principles of Securities Regulation, and Insurance Core Principles (see FSF 2000a, 2000b, 2001).²³

There are a few findings supporting the market-based perspective. A study by the Institute of International Finance indicates that subscribers to the of Special Data Dissemination Standard, set by the IMF, are able to borrow at a rate that is 200-300 basis point (b.p.) lower than the rate paid by non-subscribers (FSF 2001: 5). Rafael La Porta, et al. (2002) argue that better protection of outside investors of firms, which is a key element of the Insolvency and Corporate Governance Standards, tends to promote the firms' corporate value; well-protected outside investors are willing to pay more for the financial assets of the firms, as they expect to receive more of the firms' profits as interest or dividends as opposed to being expropriated by the entrepreneurs who control the firms. In addition, Simmons (2001) argues that market forces may provide incentives for small countries to emulate the unilateral regulatory innovations of the dominant state (the United States) in the international financial system. She presents the case of accounting standards for public offerings as an example; a number of foreign firms have adopted the U.S. generally accepted accounting principles, which are the standards any firm listed on a U.S. exchange must use.²⁴

A noteworthy element of the market-based perspective is that the importance of the implementation capacity of national authorities in ensuring compliance by regulatory-target firms may decrease under the effective operation of the market compliance mechanism. Susmita Dasgupta, Benoit Laplante, and Nlandu Mamingi (1998), for example, show that pollution control regulations were effectively implemented in developing countries—Argentina, Chile, Mexico, and the Philippines—despite the incompetent implementation capacities of the national regulatory authorities. They argue that in lieu of fines or penalties used by the regulatory authorities, capital markets penalised firms with adverse environmental incidents and rewarded firms with positive environmental news. Market-based theorists do not preclude the possibility that national authorities concerned with the competitiveness of firms in their jurisdiction may lead the firms to comply with international regulatory regimes. Yet, they stress regulatory-target firms' voluntary compliance, which is induced by the direct effect of market

²³ eStandards Forum, which is a private entity, provides information on more than eighty countries' compliance with the twelve standards on its website, www.estandardsforum.com/servlet/home.

²⁴ Simmons (2001) also attributes the international harmonisation of bank capital regulations on the BIS standard mainly to market pressures.

pressures on their own compliance-related cost/benefit calculations.

The domestic perspective

Domestic politics may also affect compliance. In this view, government policy is influenced by the underlying identities, interests, and power of domestic groups who constantly put pressure on the central decision makers to pursue policies consistent with their preferences (Moravcsik 1997: 518). Domestic groups that have ideological preferences for, or economic interests in, certain international regulatory regimes may pressure their governments to comply with the regimes. Andrew Moravcsik (1995), for example, shows that international human rights regimes could be remarkably successful in western Europe due to the maturity of civil societies, which pressured their governments to comply with the regimes in order to improve their own democratic systems. In this study, such pressure from domestic groups for compliance with international regimes is termed the *domestic compliance mechanism*.

The effectiveness of the domestic compliance mechanism depends on the capacity of domestic groups to influence government policy. In a study of immigration policy in Japan, Amy Gurowitz (1999) argues that the attitude of government, which has its own preference towards international standards, is an important variable that affects the influencing ability of domestic groups. The Japanese government had become sensitive to the issue of internationalisation and international reputation since the 1990s. Pro-immigrant groups could induce changes in Japanese migration law by exploiting the sensitivities of the government towards international standards, asserting that government policy did not meet the international standard. Meanwhile, in a study of human rights campaigns, Margaret E. Keck and Kathryn Sikkink (1998) show that domestic groups that lack domestic channels to influence government policy can use international allies (transnational actors) to apply pressure to the government to change policies from the outside.

Xiuan Dai (2005) provides a framework to analyse governments' decisions concerning compliance, with a focus on the domestic distributional consequences of international regimes. Compliance with an international regime has domestic distributional consequences. Within a country, some groups may gain while others may lose due to the government's degree of compliance with the regime. Trade treaties, for instance, affect import competing firms and consumers differently. Meanwhile, domestic constituents have the power to sanction the government through various

mechanisms, because national leaders should be accountable to a variety of constituencies with competing claims in order to remain in office. Therefore, in making a decision on the degree of compliance with an international regime, policymakers have to consider how it may affect the welfare of each different group of constituents. On the one hand, large interest groups that have significant electoral influence may induce the government to make the compliance decision biased to their interests. On the other hand, compliance decisions may reflect special interests if they are better informed about the policy process vis-à-vis other groups.²⁵ Accordingly, Dai argues, a government's compliance decision is determined by the electoral leverage of domestic constituencies and their informational status.

Although the domestic perspective stresses compliance pressure from domestic groups, it, along with other compliance perspective, also pays attention to the role of international regimes. International regimes may create focal points in the domestic arena (Checkel 2001: 558). International organisations may also increase the number of those who favour compliance through a means such as writing compliance provisions into international agreements and providing the information to potential victims of noncompliance. Alternatively, they may enhance the capacity of domestic groups to monitor their governments by publishing information associated with compliance and making it easier to assess the governments' compliance or by publishing government reports and thereby enabling domestic groups to check them (Dai 2005: 384). In this way, international regimes may facilitate domestic enforcement of compliance.

Of note is that rationalists and constructivists hold different views of actors' preferences. Rationalists assume the stability of preferences. Actors' interests may change, but change occurs slowly and as a function of the new incentive structures they face (Checkel 2001: 556). Accordingly, for rationalists, the existence of pre-formed domestic groups that favour compliance is essential in generating domestic enforcement. In contrast, constructivists argue that compliance can occur due to changes in the actors' preferences, which generate new patterns of behaviour, through social learning (Checkel 2001: 560-564).²⁶ Transnational networks such as epistemic communities, which are "network[s] of professionals with recognised expertise and competence in a particular domain and an authoritative claim to policy-relevant knowledge within that domain or

²⁵ The relatively better-informed group is more likely to determine its approval of the government based on the actual policy rather than on noise in the policy process (Dai 2005).

²⁶ The literature on policy transfer provides rich analyses of important issues in regard to learning, such as who learns, what is learned, and what effects on resulting policies emerge as a result of learning. For a review of the literature, see Bennett and Howlett (1992).

issue-area” (Haas 1992: 3), are important sources that provide learning. For constructivists, international regimes may generate new domestic supporters of compliance by changing their preferences (Checkel 2001: 567-570; Haas 1992: 4).

1.3 The argument

This study demonstrates that while all three case countries—Japan, Korea, and Taiwan—formally complied with the BIS standard throughout the 1990s and the early 2000s, comprehensive compliance occurred only in Korea and Taiwan for limited time periods. The regulatory authorities in all these countries incorporated the BIS standard into the domestic regulations, and most banks in each of the countries met its formal provisions during the 1990s and the early 2000s. However, the formal compliance by the banks made little contribution to their actual capital soundness, the key objective of the Basel Accord. The national regulatory authorities even adopted policies that had an adverse effect on the banks’ capital soundness in order to ensure that they complied with the BIS standard formally. Comprehensive compliance occurred only in Taiwan during the early 1990s and in Korea after the financial crisis of 1997. Did the compliance mechanisms indicated by the three perspectives operate for the BIS standard? What factors explain the differences in compliance between these countries and over different time periods?

Explicit or potential compliance pressures from foreign countries and from the markets—along with the domestic compliance mechanism where it operated—played a key role in inducing formal compliance with the BIS standard in all three countries. The regulatory authorities in all the countries expected that banks not complying with it would be penalised in the foreign markets or in international financial markets. This concern for banks’ international business activities gave the regulatory authorities a strong incentive to adopt and maintain the BIS standard. These external compliance pressures also led, to some extent, to formal compliance with the BIS standard by banks, although the primary incentive for the banks for formal compliance stemmed from potential penalties from their regulatory authorities.

However, the compliance pressure from foreign countries and the pressure from the markets were not effective in ensuring comprehensive compliance with the BIS standard. Foreign countries forced or encouraged the case countries to comply with the BIS standard formally. Yet, the costs to a country of requiring a foreign country to comprehensively comply with the BIS standard were higher than simply requiring

formal compliance. As a result, there was no substantial pressure from foreign countries on the three case countries to comply with the BIS standard comprehensively throughout the 1990s and the early 2000s. There was one exception: Korea under the IMF programme. In this case, the costs for the IMF to force Korea to comprehensively comply with the BIS standard were lowered since Korea was bailed out by the IMF. Yet, even in this case, the IMF could not fully impose its policy measures on the country due to strong domestic opposition.

Meanwhile, whereas there was market pressure on banks in the case countries to formally comply with the BIS standard, the markets did not put pressure on the banks to comply with it comprehensively. For the market compliance mechanism to operate for the BIS standard, market participants should have had to agree not only on its generic principles and objectives, but also on its detailed rules. However, market participants did not credit or sufficiently value the BIS standard, which was established by national regulators, with a reliable regulatory framework. Consequently, there was no market pressure for comprehensive compliance with the BIS standard. In fact, the market pressure for formal compliance with the BIS standard was not compliance pressure based on the market compliance mechanism referred to in this study. The market pressure was based on market participants' expectations that banks failing to comply with official regulations would be punished by the regulatory authorities. In other words, the market pressure was a reflection of the domestic implementation of the BIS standard in the three case countries.

Pressure to achieve comprehensive compliance arose mainly when the domestic compliance mechanism operated. The operation of the domestic compliance mechanism was based on the voluntary agreement by domestic groups on both the objectives and the specific rules of the BIS standard; as a result, the compliance mechanism operated for comprehensive compliance with it. A key potential domestic group to support compliance with the BIS standard was the national bank regulatory authority. Accordingly, the operation of the domestic compliance mechanism in a country was affected by the compatibility between the BIS standard and the country's bank regulatory arrangements. Where the compatibility was low, the domestic compliance mechanism did not operate effectively, even if the regulatory authority helped banks' formal compliance due to external compliance pressures. Conversely, where the compatibility was high, the regulatory authority was willing to achieve comprehensive compliance. Comprehensive compliance with the BIS standard depended primarily on the willingness and the capacity of the national regulatory authorities.

Yet, the implementation of the BIS standard by national regulatory authorities was influenced by domestic economic and political conditions. In particular, this study identifies three salient domestic factors: the capacity to deal with compliance failures by banks, the domestic distributional effects of compliance, and the independence of the regulatory authorities. A country's capacity to deal with the negative consequences of the banks' failure to formally comply with the BIS standard was an important precondition for the bank regulatory authority to implement the standard in earnest. A stricter implementation of the BIS standard could increase the number of formal compliance failures by banks. Therefore, when a country had no capacity to effectively deal with the negative consequences of compliance failures by banks, the government could not implement the BIS standard strictly. This capacity problem frequently stemmed from political sources rather than resource constraints.

Even if a country did not face the substantial negative consequences of formal compliance failures, the regulatory authority had to overcome domestic opposition to compliance, not only from banks but also from other domestic groups adversely affected by compliance with the BIS standard, in order to achieve comprehensive compliance. Where the capital ratios of banks were low, the costs of compliance with the BIS standard were diffused from the banks to firms as the banks reduced loans in order to comply with the BIS standard. As a result, opposition to the strict implementation of the BIS standard emerged from the firms, as well as from the banks. In this situation, even if the regulatory authority overcame opposition from the banks, the implementation of the BIS standard was affected by the degree of independence of the regulatory authority from the pressure to protect the firms. When a regulatory authority was vulnerable to the pressure, it could not implement the BIS standard strictly in spite of its own willingness. Only where the domestic compliance mechanism operated for the BIS standard and these three domestic factors did not negatively affect its operation, could a high degree of comprehensive compliance with the BIS standard be achieved.

Before proceeding further, I should be explicit about what this study does *not* try to do. First, this research does not attempt to conduct an in-depth analysis of banks' *own* regulatory capital arbitrage independent from regulatory policies.²⁷ Banks' regulatory

²⁷ One primary example of regulatory capital arbitrage by banks is cherry-picking, which refers to the practice of shifting the portfolio's composition towards lower quality credits within a particular risk-weight category (Jackson, et al. 1999: 22-26). For more practices of regulatory capital arbitrage by banks, see Jackson et al.(1999: 22-26).

capital arbitrage may be considered a form of cosmetic compliance with the BIS standard, and it is a crucial concern of economists and bank regulators. However, in this study, the analysis of measures of cosmetic compliance confines its focus mainly to those stemming from regulatory policies.²⁸ Second, this study is not intended to be a defence of or support for “international standards” or “best practice.” This study does not argue that a country’s comprehensive compliance with the BIS standard necessarily increases its welfare or the global welfare. Although the stability of the international banking system may be a public good, it is not clear whether comprehensive compliance with the BIS standard is always positively related to it.²⁹ The BIS standard is simply viewed in this study as a benchmark to understand compliance with international regulatory regimes, and to explain the factors that affect decisions regarding compliance with them.

1.4 Methods and organisation

The main methodology used in this research is a comparative study. Japan, Korea, and Taiwan are selected as the case countries for four reasons. First, the traditional bank capital adequacy regulations in the three Asian countries until the late 1980s suggest that these countries’ regulatory authorities had little need for the adoption of and compliance with the BIS standard from the perspective of bank regulation *per se* when the BIS standard was established in 1988.³⁰ Whereas there was growing emphasis on bank capital adequacy in Western countries—especially in the United States and the United Kingdom—through the early and mid-1980s, the case countries paid little attention to the issue during this period. Nevertheless, all the three countries adopted the BIS standard and banks in the countries complied with it at least formally throughout the 1990s and the early 2000s. Therefore, why these countries adopted the BIS standard and banks in the countries formally complied with it is an important question for the study of compliance with international regulatory regimes.

²⁸ Successful regulatory capital arbitrage by banks may have reduced the need for regulatory forbearance. This may be a potential problem of this research. However, this study deals with this problem by investigating regulatory authorities’ attitudes towards the BIS standard.

²⁹ In fact, there was a growing consensus that the BIS standard was in some ways dysfunctional, and, as a result, the new capital adequacy framework to replace the BIS standard was established by the Basel Committee in 2004. However, there was no formal interstate agreement about the non-efficiency of the BIS standard and its replacement by a new capital adequacy framework until June 1999, when the Committee issued the first consultative paper on the new capital adequacy framework.

³⁰ This issue will be discussed in detail in Chapter 3.

Secondly, there were significant differences in the three countries in the factors that may have influenced the operation of the three compliance mechanisms and, in turn, compliance with the BIS standard.³¹ Japanese banks' engagement in international banking was far higher than Korean or Taiwanese banks. Therefore, the magnitude of negative externalities that would have been generated by noncompliance by these banks with the BIS standard varied substantially. In this regard, differences in the compliance pressure from foreign countries on the case countries can be expected. Banks' sensitivity to market forces also varied across the countries; it was higher for Japanese banks than Korean or Taiwanese banks. Accordingly, the incentives for these banks to respond to market compliance pressures may have differed. The degree of compatibility between the BIS standard and bank regulatory authorities' preferences, which was a potential key variable affecting the operation of the domestic compliance mechanism, was different across the countries; the compatibility increased in Taiwan from the late 1980s and early 1990s, while in Korea and Japan it increased only from the late 1990s. Accordingly, comparison of the three cases can shed light on the effect of the degree of compatibility on compliance with the BIS standard.

Thirdly, these case countries also differed in the three main domestic factors that affected the capacity of regulatory authorities to implement the BIS standard—the capacity to deal with compliance failures, the domestic distributional effects of compliance, and the independence of the regulatory authorities.³² In addition, Japan was a member of the Basel Committee, which established the Basel Accord, while Korea and Taiwan were not. Therefore, the selection of both Japan and the countries not on the Basel Committee has an advantage of investigating whether formal membership of the BIS-standard regime influenced compliance.³³

Finally, the three case countries may make “comparable” cases for, in John S. Mill's (1843) term, “method of difference,” or in Adam Prezeworski and Henry Teune's (1970) term, “most similar systems” design. In terms of the socio-economic system, these countries are broadly described as “Confucian capitalism” countries, sharing the common cultural heritage of the Confucian tradition (such as emphasis on a strong state and political authority, education and self-cultivation, frugality and thrift, hard work and discipline, social harmony and group orientation, social civility, the role of intellectuals,

³¹ The differences between the case countries will be discussed in detail in later chapters.

³² The differences between the case countries will be discussed in detail in later chapters.

³³ The establishment of the Basel Accord will be discussed in detail in Chapter 4.

and so forth) (Jun 1999: 192).³⁴ The politico-economic systems of the countries share, to some extent, characteristics of a “developmental state”—for example, the competence of the bureaucracy.³⁵ The corporate finance systems in these countries are commonly characterised as a bank-centred system. In addition, financial liberalisation was augmented in all the countries during the 1980s and the 1990s.³⁶ Therefore, the selection of the three countries for comparison allows one to hold constant a large number of cultural, political, and economic variables in explaining their compliance with the BIS standard.³⁷

The observation period of compliance is from 1988 to 2003. Compliance with the BIS standard during this long period may have consisted of a series of games, and they may have differed systemically from those of earlier phases in terms of patterns of actors’ participation and the distribution of their influence. Therefore, in addition to the cross-country comparison, this research adopts a longitudinal comparative study in analysing compliance with the BIS standard within a single country. The periods of compliance within a single country are divided according to any substantial change in the nature of the compliance. However, this research does not neglect the possibility that, even if the nature of compliance was consistent on the surface for a certain period, the factors explaining it may have differed over the period. The adoption of a longitudinal comparative study for each of the case countries increases the number of observations of compliance while improving the control of variables.

The state is conceived as a complex organisation, instead of a unitary entity. This perception of the state is helpful in addressing domestic politics surrounding compliance with the BIS standard. While it was the government that made a formal commitment to the BIS standard and incorporated it into domestic regulations, the real purpose of the BIS standard was not to affect state behaviour but to regulate bank behaviour. As a result, there was the possibility that noncompliance with the BIS standard was caused by implementation failures.³⁸ The assumption of the state as a unitary actor risks the

³⁴ For Confucian capitalism, see Berger and Hsiao (1988), Tai (1989), and Tu (1996)

³⁵ For the developmental state, see Amsden (1989), Cheng, Haggard and Kang (1996), Evans (1995), Johnson (1982), Wade (1990), Weiss and Hobson (1995), and Woo (1991).

³⁶ For financial liberalisation in the case countries, see Calder (1997), Dwyer (1997), Rosenbluth (1989), Thurbon (2001), Woo-Cumings (1997), and Zhang (2002).

³⁷ Japan is qualitatively different from Korea and Taiwan in terms of economic size and level of economic development (see Park 1994: 6). Nonetheless, Korea and Taiwan are most developed economies along with Japan (and Singapore and Hong Kong) among Asian countries. Therefore, the selection of these two countries along with Japan increases comparability, while maintaining the advantages of making a comparison between Asian countries.

³⁸ Robert D. Putnam (1988: 438) uses the term “involuntary defection” in referring to the

neglect of this important cause of noncompliance. In addition, it was certain domestic groups that favoured compliance with the BIS standard or faced external pressures to comply with the BIS standard. Therefore, the conceptualisation of the state as a complex organisation is necessary for the study to explain the domestic politics of compliance.

In analysing compliance, this research focuses not only on compliance records but also on implementation. Given that compliance may occur without implementation, a compliance study concentrating exclusively on compliance records may be trapped by the problem of endogeneity (Downs, et al. 1996: 382-383). In contrast, the study of implementation may provide an analysis of the extent to which compliance records have intended or unintended consequences. In addition, implementation failure/success is not only a matter of will, but also a matter of the capacity of the implementing bodies (Hanf 2000: 15). Accordingly, the study of implementation can provide a careful analysis of what factors affect compliance.

Although the main subject of this study is compliance with the BIS standard, this study also addresses why countries made a commitment to the BIS standard: for Japan, one of the countries that created the Basel Accord, the reason that the country agreed to establish it, and, for Korea and Taiwan, which were not formally required to adopt it, the reason that they made a decision to adopt the BIS standard voluntarily. It should be emphasised here that this research does not assume that compliance with the BIS standard is a mixed-motive game—in other words, a country would gain from compliance, while it would gain more from defection. The assumption of compliance with the BIS standard as a mixed-motive game hinders the analysis of the reason that countries not formally obliged to comply with the BIS standard did adopt it, but complied with it only cosmetically. The nature of commitment may make different patterns of demands for compliance (see Smith and Clarke 1985: 6). Thus, research about a country's commitment to the BIS standard is critically important in understanding the country's compliance with the BIS standard. Of course, this study demonstrates the awareness that compliance decisions in later stages may be different from initial compliance decisions at the commitment stage, due to changes in the compliance and implementation environments.

The following chapters are organised to provide a thorough examination of why and how the case countries complied with the BIS standard. Chapter 2 builds the analytical

inability of a government to comply with an international agreement because of the failed domestic ratification of the agreement.

framework of this research. The dependent variable of this research, the extent of compliance with the BIS standard, is clarified in the chapter, based on the analysis of the objectives and provisions of the Basel Accord and the factors affecting the effectiveness of its compliance. The chapter also constructs hypotheses relating to the operations and the compliance outcomes of the key explanatory variables, the three compliance mechanisms, and discusses how to test them.

It is necessary to analyse the traditions of bank regulation, including capital adequacy regulation, in the case countries prior to the establishment of the Basel Accord, because they may have affected the views of bank regulators and banks in the country. Chapter 3 addresses this issue, and in it, I clarify which entity had the primary authority in bank regulation in the case countries, focusing not only formal but also on the informal institutional arrangements. Then, I investigate whether the regulatory authorities had a strong tradition of prudential regulation and how the existing arrangements of bank regulation influenced the authorities' view of the BIS standard. This chapter highlights the difference between bank regulators in Japan, Korea, and Taiwan in terms of their views on the desirability of the adoption of the BIS standard.

Chapter 4 considers the role of external pressures from foreign countries and markets to comply with the BIS standard. The study of external compliance pressures addresses bank regulatory authorities' and banks' perception of external compliance pressures, as well as the actual operation of those compliance pressures. The analysis of compliance pressure from foreign countries begins with an examination of the establishment of the Basel Accord and extends into the post-establishment period. The analysis of compliance pressure from markets is carried out with a focus on how market participants assessed the BIS standard and how they incorporated banks' compliance into their analysis of the banks' soundness. Along with the previous chapter, this chapter provides a concrete analysis of the commitment decisions made by the bank regulatory authorities and banks.

Chapters 5 through 7 address in detail compliance with the BIS standard in Japan, Korea, and Taiwan respectively. These chapters are structured similarly, assessing the nature of compliance with the BIS standard in the countries by examining their domestic regulations related to the BIS standard and comparing the regulations with the objectives and the provisions of the Basel Accord. The chapters analyse the effects of the operation of each of the three compliance mechanisms on banks' compliance with the BIS standard by presenting an in-depth study of the banks' compliance records. Additionally, the chapters address why the bank regulatory authorities exercised

regulatory forbearance in implementing the BIS standard. Despite the common structure, each chapter is organised in such a way to highlight the major domestic factors that influenced compliance with the BIS standard in the country it addresses.

In the final Chapter 8, I summarise the major findings of this study and comprehensively analyse what determined compliance with the BIS standard by revisiting the hypotheses developed in Chapter 2 and comparing compliance in the three case countries. I also specify the contribution of this research to the literature on compliance, discussing the applicability of the findings to other issue areas, and its implications for international political economy (IPE) in general. This study concludes by making a brief comment about Basel II, the new international capital adequacy framework, which will replace the BIS standard from 2006.

CHAPTER 2

Conceptual Framework

Chapter 2 outlines this study's analytical framework to address compliance with an international regulatory regime whose real object is to regulate private firms, in particular, the BIS-standard regime. To analyse the nature of compliance with the BIS standard, the meaning of the effectiveness of the capital adequacy regime based on the BIS standard should be firmly established. Therefore, this chapter begins with an examination of the rationale for bank capital adequacy regulation. It then presents the objectives and the provisions of the Basel Accord and clarifies the conditions for compliance with the BIS standard to be effective in terms of its objectives. It is then specified how to assess the extent of compliance, the dependent variable of this research, by articulating the key areas to observe. Thereafter, hypotheses are constructed relating to the operation and the compliance outcome of each of the three compliance mechanisms, the key explanatory variables, and the testing of these hypotheses in the context of the BIS standard is then discussed.

2.1 Capital adequacy regulation

For the analysis of compliance with a regulation, the characteristics of the regulation should be addressed first. The BIS standard was a minimum capital adequacy ratio (CAR) regulation for banks, which meant that banks had to maintain their capital over a certain level. This section analyses the rationale for capital adequacy regulation and the objectives and provisions of the Basel Accord, and subsequently discusses the accounting rules that affect the effectiveness of the capital adequacy regulation.

The case for bank regulation and the role of bank capital

The core rationale for the (government-imposed) regulation of banks is pertinent to the prudential concern of the stability of financial systems. The range of negative effects of bank failures is not limited to directly concerned parties, such as depositors or investors. Banks have a pivotal position in the economy in that they manage the payments system.

Therefore, if the banking system is placed in jeopardy, the resultant financial disruption is likely to cause larger negative externalities to the financial system than other financial institutions. Furthermore, the failure—or the perceived threat of failure—of one bank may make other sound banks face runs, which can culminate in a systemic crisis (Goodhart, et al. 1998: 10-11).³⁹ Stability of banking is an essential pillar of general financial stability, which is in turn a crucial ingredient for economic growth (Barth, et al. 2001b: 1). Martin S. Feldstein (1991: 15), a prominent Harvard economist, argues:

The banking system as a whole is a “public good” that benefits the nation over and above the profits that it earns for the banks’ shareholders. Systemic risks to the banking system are risks for the nation as a whole. Although the managements and shareholders of individual institutions are, of course, eager to protect the solvency of their own institutions, they do not adequately take into account the adverse effects to the nation of systemic failure. Banks left to themselves will accept more risk than is optimal from a systemic point of view. That is the basic case for government regulation of banking activity and the establishment of capital requirements.

Indeed, even though there is still no consensus among academics on whether banks need to be regulated, and, if so, how they should be regulated (see Santos 2000), banking is, in practice, one of the most heavily regulated industries, even among financial institutions.

Bank capital regulation is justified by the rationale that it will reduce the probability of bank insolvency. Capital provides a buffer for banks to absorb unexpected losses. Therefore, highly-capitalised banks are more likely to be able to withstand asset losses and consequently are less likely to fail. As a result, capital can provide public confidence. Indeed, bank regulators have traditionally asserted that “strong banks” are

³⁹ Banks are prone to runs due to their provision of liquidity services. To provide liquidity services, a bank needs to operate with a balance sheet in which the liquidation value of its assets is less than the value of liquid deposits. Under these circumstances, a bank may face a run without the release of negative information about the bank or even when perfect information exists about the bank’s assets, given that depositors’ expectations about the value of their deposits depend on their place in line at the time of withdrawal because of the “first come, first served” rule. If depositors panic, they may try to withdraw their deposits before others, and this can force an otherwise sound bank into bankruptcy. When there is asymmetry of information about banks’ assets, banks are susceptible to an additional source of runs; the release of information on the value of a bank’s assets can cause a run against the bank. Bank runs are costly because they force the premature liquidation of assets, thus disrupting the production process (Santos 2000: 5-6). Distress selling of assets may induce insolvency in what would otherwise be a solvent bank, because the market is unable to assess the quality of the assets being sold due to problems resulting from asymmetric information (Goodhart, et al. 1998: 11).

those with relatively high levels of capital, while “weak banks” are highly leveraged (Kapstein 1992: 275-276). In addition, in most countries, bank regulators have required banks to hold adequate capital against potential losses arising from their business operations. “Adequacy” is expressed as the minimum numerical ratio which banks are expected to maintain (Cooke 1990: 312).

On the other hand, capital has a significant impact on the competitiveness of banks. Where the cost of capital surpasses marginal interest rates, a more leveraged bank enjoys a cheaper cost of funds. Equity is usually costlier than debt because equity is more risky and receives less favourable tax treatment.⁴⁰ Thus, a bank with a lower capital level may enjoy a competitive advantage over a bank with a higher capital level by allowing the former to charge borrowers a lower rate of interest and making the same spread (profit) as highly-capitalised banks (Scott and Iwahara 1994: 5). Highly-capitalised banks may have to charge more to obtain the same return as a weakly-capitalised one. However, with asymmetric information, market participants may evaluate the two banks similarly, and as a result, the weak bank may increase its market share. Therefore, in the absence of minimal regulatory capital, there may be a tendency for banks to hold less than socially optimal amounts of capital, and banks with less capital may dominate markets (Kapstein 1992: 276).

To summarise, the main rationale of capital adequacy regulation is that the failure of a bank may trigger a systemic crisis. Regulatory capital requirements are justified in that they may reduce bank failures, and, in turn, may be conducive to the stability of financial systems. Also, different levels of capital between banks can have a significant effect on their competitiveness. This understanding of the role of capital was reflected in the Basel Accord.

The Basel Accord

The Basel Accord was established by the Basel Committee on Banking Regulation Supervisory Practices (typically called the Basel Committee) in 1988.⁴¹ The Basel Committee was established by the central bank governors of the Group of Ten (G10) countries at the end of 1974. Its members are represented by their central banks and by the authority with formal responsibility for the prudential supervision of the country’s banking business (where this is not the central bank). The Committee meets four times a

⁴⁰ Interest payments are tax deductible, but dividends are not (Berger, et al. 1995: 395).

⁴¹ The Committee was renamed as the Basel Committee on Banking Supervision in 1990.

year, and its major function has been to formulate supervisory standards and guidelines and recommend statements of best practice (BCBS 2002).⁴² The Committee presented a proposal for the Basel Accord in December 1987, and after a consultative process it published *International Convergence of Capital Measurement and Capital Standards*, which has been known as the Basel (Capital Adequacy) Accord, in July 1988. The Accord established a common capital adequacy framework for Committee member countries.

The Accord had two fundamental objectives.⁴³ One was to strengthen the soundness and stability of the international banking system. The Accord was designed to prevent the decline of banks' capital below a certain level. The minimum capital ratio requirement was expected to help banks withstand unexpected losses and therefore reduce the probability of their failures. The other objective was to level the playing field between banks. If other things are equal, disparities in national capital regulations give competitive advantages to banks subject to more lenient regulations (Kapstein 1992: 276). The establishment of a common framework to measure capital adequacy and a common minimum capital ratio requirement was expected to diminish competitive inequality stemming from different capital levels.

The Accord's capital adequacy ratio (hereafter BIS CAR) was computed by dividing total capital by total risk-weighted assets on a consolidated basis. Capital was divided into tier 1 capital and tier 2 capital. Tier 1 capital was composed of permanent shareholders' equity (issued and fully paid ordinary shares/common stock and perpetual non-cumulative preference shares) and disclosed reserves (created or increased by appropriations of retained earnings or other surplus, for example, share premiums, retained profit, general reserves and legal reserves). Tier 1 capital was the core capital, because its elements were common in the banking systems of all the countries, because it was wholly visible in the published accounts and was the basis on which most market judgements of capital adequacy were made, and because it had a crucial bearing on profit margins and a bank's ability to compete. Tier 2 capital was the supplementary capital, comprising undisclosed reserves, asset revaluation reserves, general provisions/general loan-loss reserves, hybrid (debt/equity) capital instruments and subordinated debt.

The sum of tier 1 and tier 2 elements formed the total capital base, but there were

⁴² See Tamura (2003a: ch. 2) for a detailed explanation about the role and activities of the Committee.

⁴³ The Basel Accord is available at the website of the BIS, www.bis.org/bcbs/publ.htm.

some restrictions. The total of tier 2 elements was limited to a maximum of 100 percent of the total of tier 1 elements. Subordinated term debt was limited to a maximum of 50 percent of tier 1 elements. The amount of general provisions/general loan-loss reserves eligible for inclusion in capital was limited to a maximum of 1.25 percent of risk assets. Only 45 percent of unrealised gains on securities holdings could be included in capital. Goodwill was deducted from tier 1 capital. Investments in subsidiaries engaged in banking and financial activities that were not consolidated in national systems were deducted from the total capital base to prevent multiple uses of the same capital resources in different parts of a banking group.⁴⁴ Banks' holdings of capital issued by other banks and financial institutions—in other words, double-gearing—were deducted from their capital bases, but, where no deduction was applied, banks' holdings of other banks' capital instruments bore a risk weight of 100 percent.

The capital adequacy framework adopted a weighted-risk ratio, in which capital was related to different categories of assets or off-balance sheet exposures, weighted according to broad categories of relative risk. Five categories of risk weight (0, 10, 20, 50, and 100 percent) were used, and this categorisation was based on credit risk (the risk of counterparty failure) and country transfer risk, which was a further aspect of credit risk. In this categorisation, countries were classified into two groups, OECD and non-OECD, and claims on OECD countries were allocated lower risk weights. Off-balance-sheet engagements were converted to credit risk equivalents by multiplying the nominal principal amounts by a credit conversion factor (0, 20, 50 or 100 percent), the resulting amounts then being weighted according to the nature of the counterparty. National authorities could choose either the current exposure method or the original exposure method in assessing the credit risk on interest and exchange rate related items.

A required minimum CAR was set at 8 percent. This capital adequacy framework was intended to be applied to internationally active banks. International banks incorporated in all Committee countries were expected to meet the BIS standard in full by the end of 1992. During a transitional period employed to assist banks in meeting the standard, an interim standard was set and banks were required to improve their CARs to 7.25 percent by the end of 1990.

The Committee introduced an amendment to the 1988 Basel Accord in 1996 to incorporate market risks (that is, risks of losses in on- and off-balance-sheet positions arising from movements in market prices), and Committee countries implemented the

⁴⁴ Assets representing investments in subsidiaries whose capital was deducted from that of the parent were not included in the total risk assets in computing the BIS CAR.

1996 amendment from the end of 1997. However, this research mainly focuses on the original 1988 Basel Accord. This is because the 1996 amendment maintained the core elements of the 1988 Accord, because it was not implemented in Korea until 2002 and a limited number of Korean banks were applied to the amendment,⁴⁵ and because, even though Japan implemented it from the end of (fiscal year) 1997, an extremely small proportion of Japanese banks were regulated by the 1996 amendment.⁴⁶

The effectiveness of the BIS standard

The Basel Accord did not cover all areas that affected CARs of banks. Consequently, its effectiveness in achieving its objectives required more than faithful compliance with its explicit provisions. Appropriate accounting standards in the areas that influenced the capital level of banks had to be in place for their BIS CARs to be a meaningful guide to their strengths. Some of the most critical areas were the rules of provisioning and asset classification. Their importance to the effectiveness of the Accord was recognised by the Basel Committee itself.

The soundness of a bank depends largely on the level of provisions held by the bank outside its capital against assets of doubtful value (BCBS 1988: 2). General, unforeseen risks are to be covered by capital. Meanwhile, losses that arise or are likely to arise from certain assets are to be covered by specific provisions built up against those losses (Dziobek, et al. 1995: 11). In other words, capital is supposed to be used as a buffer against unexpected losses, which specific provisions do not cover; therefore, a bank has to maintain an adequate level of specific provisions against expected losses for its BIS CAR to reflect its ability to withstand unforeseen losses.

However, the Accord did not set detailed rules of provisioning, although it prohibited banks from including specific provisions in the regulatory capital. As a result, national authorities had full discretion in deciding the level of provisions that banks were required to maintain. Where the level of provisions held by banks was not sufficient to absorb expected losses, the banks' tier 1 capital was inflated as much as the difference between the adequate level of specific provisions and the actual level. In this

⁴⁵ In Korea, the 1996 amendment was applied only to banks whose assets and liabilities under trading exceeded 10 percent of their total assets or one trillion won; this did not include regional banks (*FSS Weekly Newsletter*, 5 January 2002). In Taiwan, the 1996 amendment was adopted in 1998.

⁴⁶ As of the end of September 2003, the 1996 amendment was applied to only 9 out of a total of 132 Japanese banks.

situation, the banks' BIS CARs could not be a meaningful indicator of their soundness, as the ratios were boosted at the expense of provisioning (Dziobek, et al. 1995: 13).

Required levels of provisions for certain assets are usually determined by their risk levels, and, as a result, standards on asset classification also affect the reliability of BIS CARs of banks in reflecting their soundness. If a country's regulations for asset classification underestimate the risks of assets, the required level of specific provisions will be lower than the level adequate to cover losses from the assets, or such provisions may be categorised as general provisions. In either case, the result is the inflation of the BIS CARs of banks in the country: in the first case through an increase in tier 1 capital, while in the second case through a rise in tier 2 capital. Also, inadequate disclosure of the actual volume of risky assets, including non-performing loans (NPLs), artificially increases BIS CARs of banks by inflating income. Thus, adequate rules for asset classification and provisioning were a critical pre-condition for compliance with the BIS standard to be effective.⁴⁷

2.2 The observation of compliance

The dependent variable of this research is the extent of compliance, which ranges from comprehensive compliance to noncompliance. In analysing a country's compliance with the BIS standard, this research explores whether it was implemented in the country in line with its objectives—the strengthening of the stability of the international banking system, and the diminishing of competitive inequality among international banks. An increase in the soundness of banks in a country has a positive effect on the stability of the international banking system. Also, the strengthening of the capital soundness of banks in a country reduces competitive inequality among banks across countries, because the low capital adequacy of banks from certain countries is a source of competitive inequality.⁴⁸ Accordingly, the effectiveness of the Basel Accord may have been achieved when the real capital ratio of banks improved. Therefore, the focus of this

⁴⁷ This raises the question of why the Basel Committee did not negotiate additional rules on such important areas alongside the Basel Accord. One possible answer may have been the difficulty for the Committee to reach agreement on such broad areas. Indeed, it took five years for the Committee to agree to establish the Accord. Its establishment process will be discussed in detail in Chapter 4.

⁴⁸ Obviously, competitive equality among international banks cannot be achieved simply by their compliance with the BIS standard, even if compliance is comprehensive. Macroeconomic policies such as monetary policy arrangements and fiscal treatments can have a substantial impact on banks' international competitiveness (Cooke 1990: 311). However, the effect of such macroeconomic policies on banks' competitiveness is beyond the scope of this study.

analysis of compliance with the BIS standard is whether the BIS standard was implemented in a way that strengthened the actual capital soundness of banks. In assessing the capital soundness of banks, this study mainly addresses the following four areas: banks' formal compliance, the compatibility of the national BIS CAR formula with the Accord, adjusted CARs, and national discretionary areas. The analysis of these areas includes implementation by national authorities, as well as compliance records.

Banks' formal compliance. The first step in assessing compliance with the BIS standard is to examine whether banks actually complied with the required regulatory minimum BIS CAR. The lower were compliance costs of banks, the more easily they could achieve higher BIS CARs and be in compliance with the required minimum CAR. In other words, even if most banks in a country complied with the regulatory minimum CAR, the compliance record *per se* did not necessarily show whether the compliance was the result of adjustments made by the banks. Therefore, this research also investigates the costs incurred by banks in achieving compliance with the BIS standard in order to understand how their compliance was achieved.

The compatibility of the national BIS CAR formula with the Basel Accord. A country's formula of the BIS CAR calculation may have explicitly or implicitly violated the Basel Accord. The amount of both the numerator (capital) and the denominator (risk-weighted assets) of the formula could have been manipulated by national regulatory authorities. National regulatory authorities may have defined capital leniently, by including capital elements prohibited from being counted as regulatory capital in the Accord, or by including capital elements too ambiguous to be regarded as a violation of the Accord but having a negative effect on the actual soundness of the banks. Likewise, national regulatory authorities may have allocated inadequately low risk weights for certain assets.

Adjusted CARs. The reliability of the BIS CAR as an indicator of banks' soundness may have been undermined by national regulatory authorities' violations of the Basel Accord in implementing it, as discussed above. In addition, accounting standards that were not addressed by the Accord but affected the effectiveness of its compliance (for example, those for asset classification and provisioning) may have influenced the credibility of banks' BIS CAR as a meaningful guide to their capital strengths. Therefore, I adjust disclosed BIS CARs of banks by taking into account such factors that affected the actual capital soundness of the banks and estimate their actual CARs. The comparison between disclosed BIS CARs and adjusted CARs shows the extent to which the BIS CARs are artificially inflated without an increase in the banks' actual

soundness. Accordingly, the estimation of adjusted CARs is expected to demonstrate quantitatively whether compliance with the BIS standard in a country was effective in terms of the objectives of the Accord.

National discretionary areas. The Basel Accord allowed for a degree of national discretion in certain areas of its application. National differences in the areas may not have had a substantial impact on the effectiveness of compliance with the BIS standard. However, they may have reflected the attitudes of the national authorities towards the BIS standard. Those who adopted stricter rules in the areas at their discretion may have had a stronger incentive to use the BIS standard to strengthen the soundness of banks, and vice versa. This research concentrates on five areas: the scope of the application of the BIS standard, the required minimum BIS CAR, the elements of tier 2 capital, the risk weight for claims on domestic public-sector entities (excluding central government), and claims guaranteed by such entities, and the timing of the implementation of the BIS standard.

First, although the Accord was designed to be applied to “internationally active banks” (BCBS 1988: 2), it did not provide a clear definition of the term. It simply declared that “[a]ll banks undertaking significant cross-border business will be expected to meet the [BIS] standard,” without clarifying the meaning of “significant cross-border business” (BCBS 1988: 14). As a result, national authorities were accorded the discretion to decide the range of banks to which the Accord applied. Second, the BIS CAR requirement of 8 percent was a *minimum* target ratio. National authorities were free to adopt arrangements that set minimum BIS CAR requirements higher than 8 percent (BCBS 1988: 2). Third, national authorities had discretion in determining whether to include each of the five elements of tier 2 capital in the regulatory capital (BCBS 1988: 4). Fourth, the Accord allowed national authorities to choose either 0, 10, 20 or 50 percent risk weight for claims on domestic public-sector entities, excluding central government, and loans guaranteed by such entities (BCBS 1988: 11). Finally, while Basel Committee countries were required to implement the BIS standard in full by the end of 1992, non-Committee countries were not obliged to comply with it and were therefore free to decide whether and when to adopt it.

The lack of the development of descriptive dependent variables allowing for focused comparison has been identified as a part of the difficulty in developing and testing hypotheses about regime effectiveness (see Zürn 1998: 641). The four broad areas this research addresses in assessing compliance with the BIS standard can hardly be converted into a single quantitative measure. However, the development of clearly

defined and measurable components of the capital soundness of banks is expected to provide a focused comparison of compliance with the BIS standard in the case countries.

2.3 Three mechanisms of compliance

The key explanatory variables of this research are the operation of the compliance mechanisms proposed by the three perspectives on compliance. The three compliance mechanisms are not mutually exclusive in inducing compliance. All three compliance mechanisms may operate at the same time, and the operation of each of them may induce compliance to some extent. Therefore, the question is not which compliance mechanism induces compliance, but under what situations the compliance mechanisms actually operate and the actual compliance outcome of the operation of each compliance mechanism. In this section, I introduce hypotheses concerning the operation and the effects of the compliance mechanisms. All the hypotheses are stated with the “all else equal” clause and in probabilistic terms. The hypotheses are constructed in general terms, not confined to the BIS-standard regime. I also clarify how to test the hypotheses in the specific context of the regime.

The externality-based compliance mechanism

The externality-based compliance mechanism operates because states wish to prevent negative externality caused by noncompliance of other states. The magnitude of negative externalities of noncompliance varies across international regimes.⁴⁹ However, it may differ according to country, and even within a single international regulatory regime. Therefore, it can be anticipated that the degree of compliance pressure on countries within a single international regulatory regime will vary according to the extent of negative externalities caused by their noncompliance. There may be stronger compliance pressure from states on others whose noncompliance generates a higher negative externality. As discussed earlier in the case of money laundering, the negative-externality compliance mechanism may operate even for countries that are not official members of the regime of concern, if the negative externalities of their noncompliance with the regime are sufficiently high. The first hypothesis regarding the operation of the

⁴⁹ Botcheva and Martin (2001) argue that divergence of state behaviour—compliance or noncompliance—emerges due to domestic politics in international regimes that address issues where the externalities to state behaviour are small or nonexistent.

externality-based compliance mechanism is built as follows:

Hypothesis 1: the externality-based compliance mechanism is more likely to operate towards a country whose noncompliance generates high negative externality to other countries.

The extent of the negative externality of noncompliance with the BIS standard may be determined by the degree of engagement of banks in international finance. Failures of banks with higher international activities may pose a higher risk to the stability of international financial system and/or increase competitive inequality among international banks. As a result, the negative externality of noncompliance with the BIS standard by such banks may be more extensive. Accordingly, the externality-based compliance pressure should have been directed more at countries whose banking industry was highly connected to the international financial system.

Meanwhile, from the standpoint of states facing compliance pressure from others, they may have less incentive to comply if they are less vulnerable to compliance pressures, and vice versa. States can exercise pressure on others to comply with international regulatory regimes in diverse ways. However, enforcement methods to which states can resort may differ across regimes, depending on the regimes' "noncompliance response systems," which comprise actors, rules, and processes governing the formal and informal responses used to induce those in noncompliance to comply (Mitchell 1994: 430). The vulnerability of a country to foreign compliance pressures may be determined by the likelihood that it will be punished by the noncompliance response system of the regime of concern. Accordingly, the second hypothesis of the externality-based compliance mechanism is constructed as follows:

Hypothesis 2: the externality-based compliance mechanism is more likely to be effective for a country susceptible to the noncompliance response system other countries can employ.

The Basel Accord was not accompanied by a well-developed noncompliance response system. The Basel Committee has no formal supranational supervisory authority. Although it established the Accord, implementation in a country was the responsibility of the national authorities (BCBS 2002). Furthermore, the Accord carried

no legally binding obligations to any countries, including Committee members.⁵⁰ Nor did the Committee monitor compliance with the Accord (Whitehead 2005: 39). After all, the major noncompliance response system for the BIS standard consisted of sanctions by individual countries. In such a regime, if enforcement costs are high, countries may seek to be free-riders on the willingness of others to compel compliance.

For certain international regulatory regimes, including the BIS-standard regime, in which regulatory targets are international actors, states may have an effective means to punish noncompliance. In these regimes, states can directly force foreign regulatory targets operating in their jurisdictions to comply with the regimes. This form of compliance enforcement may be less costly than pressuring governments, since the *de jure* scope of enforcement is limited to their jurisdictions. In addition, the operation of the compliance mechanism may bring about “voluntary” compliance by the regulatory targets even in the absence of compliance pressure from their home countries, given that they are directly exposed to compliance pressure from foreign countries. This would also be consistent with the “national treatment” norm. Therefore, the enforcement ability of the regulatory targets’ domestic regulatory authorities may not have had a significant impact on the effectiveness of the compliance mechanism for such an international regime. Accordingly, for the BIS standard, the externality-based compliance mechanism may have been more effective for countries whose banks were more internationalised.

Finally, enforcement costs lead to the anticipation that countries may be reluctant to put pressure on others to comply with international regulatory regimes beyond their explicit provisions. The higher the enforcement costs are, the more reluctant states will be to exercise compliance pressures.⁵¹ For the political costs of enforcement to be low, enforcement should have firm grounds. Yet, a number of international agreements tend to choose a more general formulation of the obligation,⁵² since it is more difficult to obtain wide support for more precision, or because it is often more effective to define a general direction rather than to establish a series of detailed regulations (Chayes and Chayes 1993: 188-189). There is also the fact that diversity within each country makes

⁵⁰ The Basel Committee (2002) explicitly declares: “[i]ts [the Committee’s] conclusions do not, and were never intended to have legal force.” Indeed, simple and informal languages were used in writing the Basel Accord, deliberately avoiding legalese (Slaughter 2000: 183).

⁵¹ Enforcement problems can also arise when it is difficult to identify defectors, when countries are unable to focus retaliation on defectors, or when the defection of a country does not damage any one country substantially, even though the aggregate effect of the defection is large (Axelrod and Keohane 1986: 235; Mitchell 1996: 16).

⁵² As discussed earlier, the Basel Accord is one such international agreements.

precise and detailed rules that apply internationally difficult to make. As a consequence, international regimes often define international regulatory requirements in general terms, relying on the bona fide of the member states to effectively implement the regulations.⁵³ As a result of this tendency towards general rather than specific obligations, even if “cosmetic” compliance by a country is detected, it would be difficult to say with precision whether it is a violation of the international agreement from a legal perspective.⁵⁴ This is more likely if cosmetic compliance stems from the areas that the international agreement does not formally address. Accordingly, countries exercising extensive compliance pressure may have to bear considerable political costs in their relations with the target country. These countries may also face retaliation from the target country in other areas.⁵⁵ In view of the above, the operation of the externality-based compliance mechanism may induce only formal compliance.

Of course, in peculiar circumstances in which states exercising extensive compliance pressures do not incur high costs for particular reasons, the externality-based compliance mechanism may operate for comprehensive compliance. Yet, even in this case, if foreign compliance pressures operate through the government of the target country, rather than directly towards the regulatory targets in the country, for the foreign compliance pressures to be effective, the government has to overcome domestic opposition to compliance. In view of the above, the last hypothesis regarding the externality-based compliance mechanism is constructed as follows:

Hypothesis 3: *the operation of the externality-based compliance mechanism is likely to induce only formal compliance, unless enforcement costs are low.*

The market compliance mechanism

In analysing the role of markets in compliance with international regulatory regimes, it is important to recognise that there are two different kinds of market pressure. One is the market compliance mechanism, which the market-based perspective usually proposes. Market compliance pressures of this type emerge when market participants *accept* the desirability of the international regulatory regime of concern. The other type

⁵³ I thank an anonymous reviewer for this point.

⁵⁴ Interpretations can be deliberately invoked in order to evade obligations.

⁵⁵ Of course, the ability to retaliate differs according to country and the facts of each particular case.

of market compliance pressure operates as a *reflection* of compliance enforcement from regulatory authorities. As the natures of these two types of market compliance pressure differ, the conditions for their operations and their effects on compliance may also differ.

For the market compliance mechanism to operate in an international regulatory regime, market participants should agree both on the desirability of regulation of the issue area (that is, the objectives of the regime) and on the appropriateness of the specific regulatory methods prescribed in the regime. Accordingly, once the compliance mechanism operates, it may induce not only formal but also comprehensive compliance. In addition, the operation of the market compliance mechanism may not be affected by political borders. Thus, the formal membership of the regime may not affect the operation of this compliance mechanism. Insofar as market participants accept the regime, regulatory targets in member and non-member countries will face compliance pressures from markets.

Nevertheless, the key precondition for the operation of the market compliance mechanism is not likely to be easily met, especially for international regulatory regimes established by national regulatory authorities.⁵⁶ In general, national regulatory authorities tend to put more weight on the “public good” aspect of regulations, while market participants tend to weigh efficiency more heavily. Also, regulations by national authorities tend to lag behind market innovations (Tamura 2003a: 48-49). Therefore, market participants may not agree on the detailed provisions of an international regulatory regime, even if they do agree on the generic objectives or principles of the regime. In short, the acceptance of international regulatory regimes by markets is not automatic.⁵⁷ Nonetheless, much research from the market-based perspective has paid less attention to providing concrete evidence of the actual operation of the market compliance mechanism, and instead presumed it when market actors appeared to agree with the generic principles of the regime.⁵⁸ However, the operation of the market

⁵⁶ The participation of market actors in setting international standards has been increasing. The 1996 amendment of the Basel Accord and the Basel II are two such examples. For the establishment of the 1996 amendment, see Tamura (2001).

⁵⁷ Indeed, the Financial Stability Forum (2001) reported that it had to make efforts to encourage market participants to accept the twelve international standards highlighted by the Forum in order to promote their implementation. In situations where it is unclear what the most efficient rules are, there is a possibility that the rules promulgated by national regulators may provide a focal point for market expectations, generating market compliance pressure. (I thank Andrew Walter for this point) However, for the rules to provide a focal point for market expectations, there should be an agreement in markets that the rules are at least a second-best choice. Where the rules are not accepted by market participants as reliable, the rules cannot provide a focal point, and, consequently, the market compliance mechanism is not likely to operate effectively.

⁵⁸ See, for example, Ho (2002) and Simmons (2001).

compliance mechanism is a subject not to be assumed, but to be empirically tested. In this regard, I build the following first hypothesis regarding market compliance pressures:

Hypothesis 4: the market compliance mechanism will promote full regime compliance only when market participants accept both its generic principles and its detailed rules.

The second type of compliance pressure from markets is fundamentally different from the market compliance mechanism. Once an international regulatory regime has been implemented in a country and there are regulatory penalties for noncompliance, noncompliant regulatory targets will suffer from them. Such penalisation will have a negative effect on the targets' business. Moreover, given that regulatory targets' compliance failure would trigger regulatory actions, their failure to meet such important standards may imply that they have serious problems. Therefore, market participants pay attention to compliance of firms with regulations to which they are subject, and penalise those failing to meet the regulations. In other words, there may be pressures from markets on firms to comply with regulations even if market participants do not accept the regulations as reliable. This market compliance pressure is an additional compliance pressure stemming from the expectation of compliance enforcement by regulatory authorities. Accordingly, this market compliance pressure may require firms to comply with regulations only to the point where the level of compliance is sufficient to avoid enforcement penalties. Additionally, it may not induce firms that are not subject to certain regulations to adopt them.

Hypothesis 5: compliance pressures may come from markets as a reflection of domestic enforcement, but will not induce compliance above and beyond that required by regulatory authorities.

Regarding the BIS standard, the operation of the market compliance mechanism may induce banks to strengthen their actual capital adequacy regulations. However, the compliance mechanism might effectively operate only when market participants agreed on the desirability of the regulation of bank capital adequacy and believed in a strong relationship between a bank's official BIS CAR and its actual capital soundness. Meanwhile, even if market participants did not accept the BIS standard as reliable, the

implementation of the BIS standard in a country might lead market participants to put pressure on banks to comply with it due to expectations of domestic enforcement. However, in this case, the market compliance pressure was not likely to induce banks to comply above the level of avoiding enforcement penalties. If such penalties were applied only to formal noncompliance, the market compliance pressure might require banks to comply with the BIS standard only formally. Also, the market compliance pressure was unlikely to lead banks that were not regulated by the BIS standard to adopt it.

The effectiveness of market compliance pressures may depend on the sensitivity of regulatory targets to market forces, regardless of the type of compliance pressure. As in the case of the externality-based compliance mechanism, compliance through the operation of market pressures occurs due to the expected cost of noncompliance, that is, penalisation by markets. Therefore, market compliance pressures may be more effective if noncompliant regulatory targets incur higher costs in markets. The final hypothesis of market compliance pressures is as follows:

Hypothesis 6: market compliance pressures (of both types) are more likely to be effective for a country in which regulatory targets are vulnerable to market forces.

In the case of the BIS standard, it is not an easy task to measure the sensitivity of banks to market forces. Banks are vulnerable to market forces insofar as they raise funds from markets.⁵⁹ Nevertheless, the degree of market force may be different across markets. Banks can rely to some extent on their relationships with their traditional lenders or borrowers in raising funds. Therefore, the degree of the operation of market disciplines may be lower when banks raise more funds from domestic markets than from foreign markets, and vice versa. In this regard, in analysing banks' sensitivity to market forces, I examine the degree to which banks rely on foreign funds.

⁵⁹ Banks are also sensitive to market forces if they are excluded from transactions that require minimum credit ratings. For example, many swaps transactions require bank counterparties to be highly rated. This market pressure would apply mainly to large international banks. (I thank Andrew Walter for this point.)

The domestic compliance mechanism

The prerequisite of the operation of the domestic compliance mechanism for an international regulatory regime is the existence of domestic actors whose preferences are in accord with compliance with the regime. The existence of a domestic group that favours compliance with a particular regulatory regime may be determined by the compatibility between domestic actors' preferences and the objectives of the regime. Yet, compatibility between the preferences and the specific methods the regime prescribes to achieve the objectives is also necessary for the operation of the domestic compliance mechanism. The compliance mechanism may not operate, despite domestic actors' agreement on the objectives of the regime, if they do not agree on the effectiveness or the desirability of the prescribed methods in achieving the objectives. The logic of compatibility leads to the following hypothesis:

Hypothesis 7: the domestic compliance mechanism is more likely to operate when there is a high level of compatibility between domestic groups' preferences and both the overall objectives of the regime and its specific provisions.

In analysing domestic pressures for compliance with the BIS standard, this study focuses on a specific part of government, the bank regulatory authority, as the key domestic group that may have favoured compliance with the BIS standard, although it does not neglect the possibility that there were other domestic groups supporting compliance. For financial regulations, unlike regulations in areas such as the environment or human rights, there are few non-government groups that put organised pressure on the government to comply with specific international regimes, partly due to the high degree of technical knowledge required to understand such regulations. Even if some financial experts support the idea that financial institutions comply with certain financial regulatory standards, such support is usually sporadic and scattered. Moreover, such a demand for compliance has to be accepted by the financial regulatory authority in order to make regulatory changes. Therefore, the focus on bank regulatory authorities as the potential source of domestic compliance pressure may not cause a serious analytic problem.

Whether a bank regulatory authority actually functioned as the source of the domestic compliance mechanism may have been determined, firstly, by the compatibility between its preferences and the key objective of the BIS standard, the

strengthening of capital soundness of banks. In general, bank regulatory authorities have two main concerns in designing the regulatory system: stability and competitiveness. The maintenance of the soundness of individual banks and of the stability of the overall banking system is the primary responsibility of bank regulatory authorities. Inadequate regulations will result in costly failures, of which an extreme instance is a financial crisis. In addition, bank regulatory authorities have to pay attention to the competitiveness of banks because overregulation will put domestic banks at a competitive disadvantage to foreign banks, lowering profits and, eventually, capitalisation. Thus, bank regulatory authorities have to balance stability with competitiveness in structuring regulations in such a way that provides the desired degree of stability at the minimum cost to competitiveness (Singer 2004: 536; Walter 2002: 18).⁶⁰ An optimum regulatory structure may differ across countries, depending on the relative weight bank regulatory authorities attach to stability and competitiveness.⁶¹ The more emphasis a bank regulatory authority puts on stability, the more they may have insisted on compliance with the BIS standard.

However, the BIS standard was a very specific regulation requiring banks to raise their CARs above 8 percent based on a specific formula. Accordingly, there was another crucial condition for the operation of the domestic compliance mechanism: bank regulatory authorities perceived that banks' maintenance of a BIS CAR of 8 percent would enhance the stability of the banking systems in their countries. The improvement of capital levels of banks may have been expected to enhance the stability of the banking systems in some countries. However, there may not have been a substantial positive relationship between the two variables in others, for example, if the bank regulatory authorities maintained a policy that did not allow any banks to fail. In such a case, a requirement of high capital levels for banks would only result in a decrease in the competitiveness of the banks. Thus, the regulatory practice of bank regulatory authorities in the specific area of bank capital may have influenced whether or not they insisted on compliance with the BIS standard.

The compatibility between domestic groups' preferences and an international regulatory regime may change when their attitudes towards the desirability of the

⁶⁰ A trade-off between stability and competitiveness may be less strong in the long term than in the short term. A long run trade-off between the two is not clear given that stability and competitiveness are strongly positively related to each other in the long term. (I thank Andrew Walter for this point.)

⁶¹ Decisions on an optimum regulatory structure are made based on "what if" hypotheticals, as any improvements in financial stability due to the establishment of any regulation can only be measured in terms of costs that otherwise would have been incurred (Walter 2002: 18).

regime's objectives or the appropriateness of its specific methods to achieve them change due to learning. Learning is more likely to occur when domestic groups have few prior, ingrained beliefs that are inconsistent with the regime (Checkel 2001: 563). Also, learning may occur when domestic groups find themselves in a new and uncertain situation which may be caused by a crisis or policy failure and which drives them to search for new information (Checkel 2001: 562; Haas 1992: 14).⁶² The conditions of learning generate the second hypothesis regarding the domestic compliance mechanism:

Hypothesis 8: *compatibility between domestic groups' preferences and an international regulatory regime is more likely when the following two conditions are met:*

- . The domestic groups do not have prior, strong beliefs inconsistent with the objectives of the regime and its methods to achieve the objectives.*
- . The domestic groups are in new and uncertain environments.*

Accordingly, the compatibility between a bank regulatory authority's preference and the BIS standard may have increased when the authority had not traditionally maintained regulatory arrangements that would invalidate the effect of compliance of the BIS standard on the stability of the banking system. Alternatively, the compatibility may have become higher when the authority's regulatory practice that did not adhere to the BIS standard resulted in severe policy failures such as a financial crisis. Under these circumstances, the domestic compliance mechanism may have been more likely to operate for the BIS standard.

Pressure from domestic groups for compliance with an international regulatory regime stems from their voluntary agreement on its desirability, in terms of both its objectives and its specific provisions.⁶³ Thus, domestic compliance pressure may favour comprehensive compliance. If there is strong external pressure on a country to comply with the BIS standard, the regulatory authority may require banks to comply with the BIS standard, but may help them in practice defect from it. However, in such a case the compliance pressure from the regulatory authority would not be the operation of the domestic compliance mechanism; it would be a reflection of the external

⁶² Mitchell (1996: 8) argues that economic and technological changes over time can affect national governments' compliance decisions about whether to comply with an international regime.

⁶³ Therefore, the domestic compliance mechanism may operate in both member and non-member countries of the international regulatory regime.

compliance mechanism. The following hypothesis is introduced for the operation of the domestic compliance mechanism:

Hypothesis 9: The operation of the domestic compliance mechanism is likely to result in pressure for comprehensive compliance.

The actual outcome of the operation of the domestic compliance mechanism is influenced by a number of factors. For the mechanism to operate effectively, domestic groups supporting compliance must have sufficient enforcement power and the country should have the capacity to comply with the relevant international regulatory regime. The following section elaborates these issues.

2.4 Factors affecting implementation capacities

Even if domestic compliance pressures exist for compliance with an international regulatory regime, the capacity and ability of the relevant national authorities to implement and enforce the regime will influence the level of compliance.⁶⁴ Their lack of implementation capacity may hinder comprehensive compliance, may give rise to cosmetic compliance, or may even cause noncompliance. Capacity limitations can stem from diverse sources, including administrative, economic, or political sources (see Chayes and Chayes 1993: 193-195; Jacobson and Weiss 1998a: 529-535; Vogel and Kessler 1998). However, it is impossible for this study to address all the factors that influence implementation capacities. Instead, this study presents three particular domestic factors—the domestic distributional effects of compliance, the independence of regulatory authorities, and the capacity to deal with compliance failures—as important factors that affect implementation capacities. The domestic distributional effects of compliance influence the composition of domestic opposition to, as well as domestic support for, compliance. The independence of regulatory authorities affects the extent to which domestic opinions on compliance can be reflected in regulatory policies.

⁶⁴ As noted earlier, the operation of the market compliance mechanism provides regulatory targets with an incentive to comply voluntarily even in the absence of implementation by the domestic regulatory authorities. Also, for certain international regulatory regimes, including the BIS-standard regime, the operation of the externality-based compliance mechanism can put compliance pressure directly on regulatory targets. However, when the externality-based compliance mechanism operates through enforcement by the regulatory authorities in the countries subject to foreign compliance pressures, the implementation capacities of the regulatory authorities can also affect the effectiveness of the compliance mechanism.

The capacity to deal with compliance failures is a critical pre-condition for the strict implementation of international regulatory regimes.

The domestic distributional effects of compliance

Compliance with international regulatory regimes has domestic distributional effects. While some domestic groups benefit from compliance, others may have to bear costs generated by the compliance. Thus, the domestic distributional effects of compliance with international regulatory regimes have a critical effect on compliance because they generate domestic *opposition* to and support for compliance. Because the manner in which domestic support for international regulatory regimes may arise has been addressed by the analysis of the operation of the domestic compliance mechanism in the last section, this section concentrates on how the domestic distributional effects of international regimes affect domestic opposition to compliance. The literature on compliance/implementation does recognise that domestic opposition affects compliance outcomes. Nevertheless, there are few studies that develop a sophisticated analysis of domestic opposition to compliance. Yet, the understanding of how domestic opposition groups are formed is crucial to explaining compliance failures.

It may be obvious that regulatory targets' opposition to compliance with the international regime will increase as their compliance costs grow. Yet, where compliance costs are diffused from regulatory targets to other sectors of the economy, domestic opposition to compliance may also arise from those who are *not* regulatory targets. The extent of the diffusion of compliance costs from regulatory targets to other sectors may be determined by the economic linkage between them. If the linkage is weaker, compliance costs tend to be imposed exclusively on regulatory targets, and compliance opposition from non-target sectors will be accordingly lower. Conversely, when the linkage is stronger, the diffusion of compliance costs will be more extensive, and a larger number of domestic groups outside regulatory targets will be opposed to compliance. The success of the compliance opposition by non-target groups will be affected by their power to influence government policy. If the sectors are politically important or influential, and the sectors' potential damage is substantial, the likelihood of political intervention to oppose the compliance and protect these non-target sectors will increase. Under the circumstances, even if the national regulatory authority is willing to force the regulatory targets to comply with the regulatory regime of the concern in earnest and can overcome the regulatory targets' own opposition, the

regulatory authority may fail to implement the regime in earnest. I build the following hypothesis as to compliance failure:

Hypothesis 10: *compliance failure is more likely to occur when compliance costs are diffused from regulatory targets to other sectors comprised of politically important actors.*

In complying with the BIS standard, banks could increase their CARs by increasing capital or by decreasing risk-weighted assets. In general, banks should adjust their balance sheets in the least-costly way of meeting the BIS standard. When it was not costly to raise capital in markets—for example, during economic booms—, banks may have preferred increasing capital to curtailing risk-weighted assets. Yet, when it was costly—for example, during economic downturns—, it may have been necessary to reduce their risk-weighted assets in order to comply with the BIS standard (see Jackson, et al. 1999: 15-19). A reduction in risk-weighted assets may have been achieved with the least effect on total assets by curtailing lending, whose risk weight was the highest at 100 percent and typically the largest component of total assets (Jackson, et al. 1999: 15-19; Woo 1999: 8).⁶⁵ Given the role of banks as the core financial intermediary, their efforts to comply with the BIS standard by reducing lending may have had a significant negative effect upon other sectors in the economy. In other words, costs to comply with the BIS standards could be diffused from the regulatory targets (banks) to other sectors relying on bank loans. Banks may consciously threaten to comply via reduced lending in order to reduce compliance pressure from the authorities.

When banks reduced loans in order to comply with the BIS standard, the overall corporate sector may have been negatively affected by the reduction of bank loans.⁶⁶ However, in general, small and medium-sized enterprises (SMEs) may have been damaged more severely than large firms, because SMEs tended to have difficulty in finding alternative sources of funding to bank loans, while larger firms were able to raise funds more easily in capital markets.⁶⁷ There may have been a difference in the

⁶⁵ Much economic research on the BIS standard has found that banks with lower BIS CARs in Japan and in the United States tended to increase capital and/or reduce risk-weighted assets (see Hall 1993a; Ito and Sasaki 2002; Jackson, et al. 1999).

⁶⁶ Of course, householders may also be negatively influenced by a decrease in bank loans. However, given that they hardly exercise organised pressure on the government, this study concentrates on the effect of compliance with the BIS standard on the corporate sector.

⁶⁷ There was some indication that small firms may have been affected by pressure on bank capital in the United States in the early 1990s (see Jackson, et al. 1999: 27-35).

political importance of SMEs across countries. However, the difference was not likely to be significant, given that in most countries SMEs accounted for the majority of the employees—that is, voters—and, as a result, they were politically important actors. Accordingly, where SMEs were substantially negatively affected by banks' compliance with the BIS standard, national authorities may have hesitated to force banks' compliance with it.

Independence of the regulatory authorities

Institutional settings that influence the policy-making process in governments may also have an effect on the outcome of the operation of the domestic compliance mechanism. Domestic compliance pressures and compliance opposition are transmitted through governments or, in certain cases, come directly from them. Thus, the institutional arrangements of the government policy-making process can influence the effect of the domestic compliance mechanism.

The key institutional arrangement highlighted in this study is the independence of the regulatory authority responsible for the domestic implementation of the international regulatory regime of concern. Regulatory authorities usually participate in their governments' decisions as to whether to commit to relevant international regulatory regimes. Moreover, they are ultimately accountable for the domestic implementation of the international regulatory regimes. Therefore, they are in a key position to determine the overall compliance decisions related to the regimes. Yet, their capacity to make compliance/implementation decisions and to put those decisions into practice may be influenced by their independence from pressure from politicians or businesses. Even if regulatory authorities themselves favour compliance with international regimes, if there are strong domestic pressures against compliance and the regulatory authorities are vulnerable to pressures, compliance failure is likely to occur. Accordingly, I build the following hypothesis regarding the effect of domestic institutional settings on compliance:

Hypothesis 11: *where the independence of regulatory authorities is lower, compliance failure is more likely to occur, even if the regulatory authorities themselves favour compliance.*

In fact, for monetary policy, it is controversial whether an independent central bank

necessarily increases monetary stability for the economy. Adam S. Posen (1993), among others, argues that central bank decision-makers respond to risks that anti-inflationary policies could lead to changes in the autonomy and powers of the central bank itself, and that, as a consequence, independent central banks find it difficult to implement anti-inflationary policies when they lack the support of key social groups. If this argument relating to central bank independence and monetary stability can be applied to financial regulatory policy, the appropriateness of this hypothesis may be questioned. This problem is dealt with through analysis of the effect of the independence of the bank regulatory authority on compliance with the BIS standard by addressing whether bank regulatory authorities have the capacity to actually formulate and implement regulatory policies in accordance with their preferences, going beyond formal legal arrangements. This broad conceptualisation of independence reflects Posen's insight given that the capacity of a bank regulatory authority is affected by its level of support from powerful allies in society and/or government.

The capacity of a bank regulatory authority is influenced by the formal and informal institutional status of its regulatory separation from the executive and legislative branches of government. Factors such as the type of regulatory authority, the terms of appointment and dismissal of senior personnel of the regulatory authority, the regulatory authority's governance structure, and the openness and the transparency of its decision-making affect the institutional status of the regulatory authority. Additionally, the independence of bank regulatory authority is influenced by the ability to set, within the confines of the law, technical rules and regulations for the sectors under supervision,⁶⁸ the ability to carry out on-site inspections and off-site monitoring, sanctioning and enforcement of sanctions,⁶⁹ and the way in which the executive/legislature is involved in the determination of the size of the regulatory authority's budget and its use (Quintyn and Taylor 2002: 13-22).⁷⁰

⁶⁸ In countries where primary and secondary legislation are so detailed that little room is left for rules and regulations, the independence of the regulatory authority is limited. Conversely, in countries where primary and secondary legislation is kept general so that there is ample room for regulatory initiatives at the technical or implementation level, the regulatory authority has a higher degree of independence (Quintyn and Taylor 2002: 14-16).

⁶⁹ Legal protection of bank supervisors for supervisory activities and the adoption of a rules-based system of sanctions and interventions, appropriate salary levels and clear career streams for supervisors, as well as proper restriction of appeals by institutions that have been sanctioned by supervisors, may enhance this ability (Quintyn and Taylor 2002: 17-20).

⁷⁰ Regulatory authorities that are funded directly from the budget or through a ministry that oversees their operations may be prone to various types of political interference. In the same way, when regulatory agencies are funded from the regulated industry, there is a risk of industry capture (Quintyn and Taylor 2002: 21-22).

The capacity to deal with compliance failures

Even if the domestic compliance mechanism operates, and the regulatory authority is willing to steer towards compliance and is able to overcome compliance opposition from particular sectors, compliance failure can arise due to implementation problems emerging at the national level. Among diverse sources of systemic incapacity,⁷¹ this research pays particular attention to the capacity to deal with compliance failure. This capacity problem has attracted little attention from compliance studies. However, it may have a significant effect on compliance with certain international regulatory regimes.

The failure of regulatory targets in a country to comply with an international regulatory regime can cause the country substantial negative systemic consequences beyond the noncompliant regulatory targets themselves. This situation may occur, for example, when external penalisation, by foreign countries or by markets, of noncompliant regulatory targets in a country has a systemic effect on the country. In this situation, the government may be concerned about the negative consequences of noncompliance with the regime so that complete noncompliance is not likely to occur. Yet, in general, comprehensive compliance is more costly to achieve than simple formal compliance. Accordingly, the stricter implementation of the international regulatory regime in the country may increase the likelihood of compliance failures by the regulatory targets. Therefore, the government should have the capacity to deal with negative systemic consequences generated by the compliance failures of the regulatory targets in order to implement the international regulatory regime in earnest. Where the government lacks such a capacity, it may induce the regulatory targets to comply with the regime, but may also try to reduce compliance costs in order to avoid the negative consequences that can be generated by their noncompliance. In this regard, I build the following hypothesis:

Hypothesis 12: *when the cost of compliance for regulatory targets in a country is high, and the government lacks the capacity to deal with compliance failures by the regulatory targets, cosmetic compliance is more likely to occur.*

If there was pressure from foreign countries or markets on banks to comply with the BIS standard, the immediate negative consequences of the banks' noncompliance may

⁷¹ See, for example, Chayes and Chayes (1993: 194-195), Jacobson and Weiss (1998a: 529-535), and Vogel and Kessler (1998).

have been the penalisation of their business activities in foreign countries or markets. The banks' expansion into foreign countries may have been prohibited, or they may have been required to pay more in raising funds in markets. Such costs of noncompliance may have damaged the individual noncompliant banks in the first place. However, given the role of banks in the economy, such costs were likely to be diffused to the overall economy, especially when compliance failure was prevalent in the country. For example, noncompliance by a large number of banks in a country may have increased the cost of funds to the real economic sector, negatively affecting the overall economy. When a government was not able to bear such negative systemic consequences of banks' compliance failure, the bank regulatory authority may have implemented the BIS standard in such a way to reduce banks' compliance costs and thereby help them to comply. As a result, the compliance was likely to be cosmetic rather than comprehensive.

Moreover, the failure by a majority of banks in a country to comply with the BIS standard had the possibility to cause a systemic crisis in the country. Under the implementation of the BIS standard, the failure by a large number of banks in a country to comply with the required regulatory minimum CAR of 8 percent could signal to markets that the banking sector had serious problems. The stricter implementation of the BIS standard may have made banks' compliance with the BIS standard more difficult, increasing the likelihood of systemic instability. In this situation, if the government lacked a means to deal with troubled banks—in other words, if it did not have an adequate financial safety net—the stability of the banking system could be at risk.⁷² Therefore, where the financial situation of the overall banking sector was not sound, and there was no adequate financial safety net to deal with troubled banks, cosmetic compliance was likely to occur.

⁷² Financial safety nets refer to an amalgam of policies that are designed to prevent failures of financial institutions or to limit their effects (Memirguc-Kunt and Huizinga 1999: 2), including explicit or implicit deposit insurance, “lender of last resort” facilities of the central bank, “bailout” policies, bank closure, and so forth. Deposit insurance provides protection for unsophisticated and small depositors so that stability in payment and credit systems is maintained and contagious bank runs avoided (Barth, et al. 2001b: 10). Lender of last resort facilities, according to classical theory, provide lending for illiquid but solvent institutions (using good collateral and at a premium price) in order to solve a failure in market provision for liquidity (Freixas and Santomero 2003: 17-18). Although the bailout policy is never announced *ex ante*, governments do carry out bailout operations for banks—especially for “too big to fail” banks—due to concerns about negative externalities caused by the failures. Given that bankruptcy cost is a result of the bankruptcy resolution scheme, the mechanism for orderly liquidation forms a part of the financial safety net (Freixas and Santomero 2003: 18-20). Capital adequacy regulation, whose aim is to avoid bank failures, is also an important pillar of financial safety nets (Freixas and Santomero 2003: 15-17).

National regulatory authorities may not have the capacity to deal with compliance failures as a result of resource constraints *per se*, or for political reasons. In general, the less developed a country is the more likely it is to suffer from this problem, since financial and/or technological development tends to be low in such countries. However, even developed countries may face the capacity problem because of political factors that hinder governments from using the resources necessary to implement the international regulatory regime of concern in earnest. Therefore, in examining the capacity problem, it is necessary to distinguish whether the problem is in essence political, or whether it is resource-driven.

Conclusions

This chapter has laid out the groundwork for analysing compliance with the BIS standard. Compliance with the BIS standard can be regarded as effective only when it is carried out in a way that increases the soundness of banks. Accordingly, compliance with the BIS standard will be analysed in terms of its effect on the actual capital soundness of banks. The compliance outcomes for the BIS standard in any particular country may have been determined by which of the three compliance mechanisms were more important in any given case. Therefore, this chapter has developed the analysis of the three compliance mechanisms and has built hypotheses in regard to their operation and the extent of compliance that may result from their operation. The following chapters provide an empirical analysis of compliance with the BIS standard in the case countries of Japan, Korea, and Taiwan, drawing upon the analytical framework presented in this chapter.

CHAPTER 3

Original Views of Regulators on Capital Adequacy Regulations

The regulatory authority's attitude towards the BIS standard was a critical factor that influenced compliance with the BIS standard in each country because it was the potential main source of the domestic compliance mechanism and also because it could affect the implementation of the BIS standard in the country. Did the regulatory authorities in Japan, Korea, and Taiwan wish to adopt the BIS standard in order to strengthen their capital adequacy regulations? To answer this question, I address the tradition of financial administration in the countries until the late 1980s, the time period in which the Basel Accord was established. In particular, given that the main goal of the BIS standard as a prudential regulation was to reduce the probability of bank failures, the major focus of the analysis will be on the countries' policies governing bank failures.

3.1 Japan

A few scholars argue that the Japanese bank regulatory authority may have intended to use the Basel Accord in order to strengthen Japanese banking regulations.⁷³ However, most of the arguments are based on a very general assumption that a strong bank capital regulation would be necessary to maintain the stability of the banking system. In this section, I explain why a capital adequacy regulation was not important—or even necessary—in Japan by examining Japanese banking regulations and then analysing how the Japanese bank regulatory authority coped with the international trend of strengthening bank capital regulations during the 1980s.

The convoy system and the low need for capital adequacy regulations

Japan's statutory regulatory authority of financial institutions, including banks, was the

⁷³ See, for example, Kapstein (1992: 283), Granirer (1994: 255-256, 270-272), and Tamura (2003a).

Ministry of Finance of Japan (MFJ), until the establishment of the Financial Supervisory Agency, the new financial regulatory authority, in June of 1998. The ministry was not just a legal authority but became the actual supreme authority in the country's financial regulations. The central bank, the Bank of Japan (BoJ), shared some responsibility with the ministry in supervising banks. The Examination Bureau of the BoJ carried out regular audits on banks and collected information, and the Banking Bureau of the MFJ relied on the Examination Bureau to gather detailed information on individual banks. As a result, these two bodies were often seen as tightly united. However, the BoJ was the secondary regulator, subordinate to the ministry, which won the commanding position in the country's financial administration.⁷⁴ In the area of bank capital regulation, the Banking Bureau of the MFJ monopolised authority domestically, and was the main negotiator in international negotiations. Although the BoJ was also the other Japanese member of the Basel Committee, it was a secondary participant (Hall 1993b; Sawabe 2002: 401; Tamura 2003a: ch. 4).

The MFJ had put the foremost emphasis on stability in financial administration. The emphasis on stability had a long history, going back the early 1900s. After the great financial crisis of 1927, when a number of banks failed, the Japanese bank regulatory authority shifted its focus from the maintenance of a competitive financial system to regulation and safety. This attitude of the regulatory authority was strengthened after the devastation and disruption of World War II because they aimed to rebuild a very safe financial system which could effectively transfer the savings of the Japanese people to corporate business in order to finance new factories, equipment, and other investment (Hoshi and Kashyap 1999: 4; Patrick 2001: 4-5).

To ensure stability, the MFJ had implemented the "convoy system" in bank regulation (Amyx 2001; Hoshi 2002; Patrick 2001).⁷⁵ The core characteristics of the convoy system were the tight control of competition and the safety of every bank. The MFJ heavily regulated the banking industry through measures such as the strict segmentation of business activities between different types of financial institutions, interest rate controls, the prohibition of new entries into the banking system, the control of banks' establishment and relocation of their head offices and branches, and the

⁷⁴ The BoJ did not have full independence from the government until 1998.

⁷⁵ The term *convoy* stemmed from the World War II story that destroyers and battleships had to slow down and maintain a speed equal to the slowest ships, such as large cargo ships, in the convoy so that all of them could arrive at the destination safely (Hoshi 2002: 157). Likewise, the convoy system ensured that no banks would be left behind and that none could move forward so fast that they would endanger the viability of others (Amyx 2001: 53-54; Hoshi 2002; Patrick 2001).

control of the types of financial instruments banks could offer, in order to restrain competition and thereby prevent the emergence of failing banks (FBAJ 1989: 41; Kitagawa and Kurosawa 1994: 83-89; Mabuchi 1993: 137-139; Suzuki 1990: 35-44). When these regulatory measures could not prevent the financial deterioration of a bank and it was on the verge of failure, the MFJ arranged a merger between the failing bank and a healthy bank (sometimes more than one bank) in order to rescue the bank. The MFJ encouraged the healthy banks to absorb the failed bank by providing both personnel and financial assistance. In general, the assets and liabilities and the employees of a failed bank were taken over by a healthy bank, but the incumbent managers of the failed bank were forced to resign (Hoshi 2002: 159-161).⁷⁶

The system of the rescue merger of a failed bank by a healthy one relied on regulatory rents generated by the heavily-regulated financial system. The rescue or merger of an ailing bank by a healthy bank caused substantial costs to the healthy bank. However, such costs were compensated by regulatory rewards by the MFJ, and, as a result, the healthy bank could expect to gain some regulatory favours from the ministry by cooperating with it. For example, the MFJ rewarded cooperative banks by allowing them to expand their business by opening more branches. Given strict interest rate controls, Japanese banks had a strong incentive to open new branches in a quest for more cheap deposits. Using such regulatory rewards, the MFJ could create incentives for healthy banks to rescue troubled banks (Hoshi 2002: 162-164; Kitagawa and Kurosawa 1994: 84, 88).

Under the convoy system, the BIS capital adequacy regulation could not make much of an impression among the Japanese.⁷⁷ The capital adequacy regulation was based on the rationale that a certain CAR was necessary to prevent bank failures. However, in the convoy system, troubled banks were absorbed by healthy banks, as arranged by the MFJ. This system provided a strong and effective bank safety net to secure the reliability of banks in the country. As Hugh Patrick (2001: 5) argued, the convoy system was not based on the assumption of “too-big-to-fail,” but on the assumption that no live bank should die. No banks would be allowed to go bankrupt, and accordingly there was a low need for the implementation of the BIS standard.⁷⁸ The main focus of the MFJ in

⁷⁶ See Hoshi (2002: 158-161) for examples of such rescue mergers.

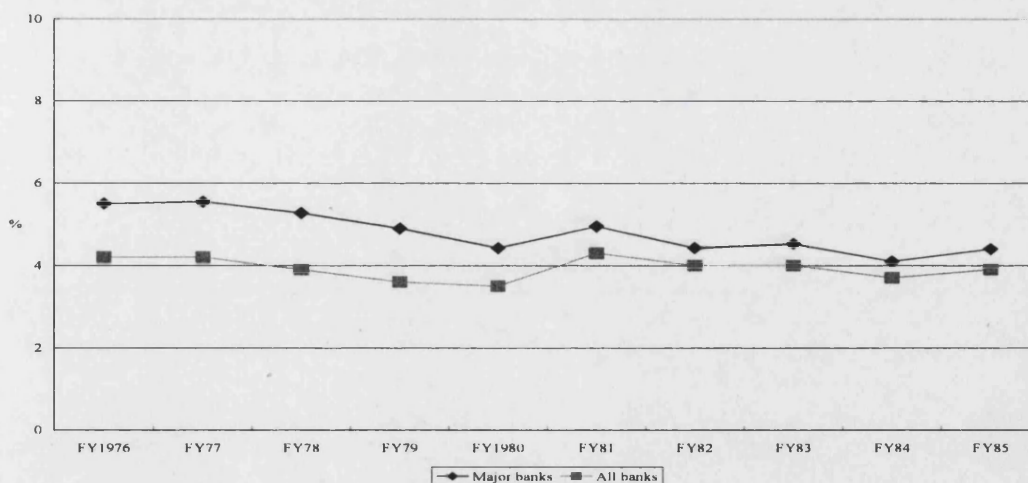
⁷⁷ Author's interview with Nishimura Yoshimasa (former Director-General of Banking Bureau, MFJ, 1994-96), Tokyo, 5 March 2004. In this thesis, Japanese, Korean, and Chinese names are kept in original format, in which family name is followed by the given name, except for the References.

⁷⁸ It is worth noting that the United States, which led the establishment of the Basel Accord,

ensuring the soundness of banks was traditionally on their asset qualities instead of their capital levels.⁷⁹

Indeed, the MFJ had traditionally paid little attention to the regulation of banks' capital adequacy. A capital adequacy regulation which required a bank to maintain their capital of no less than 10 percent of the total deposits was in place from 1954 to 1986, at which point it was replaced by the new regulations based on capital to total assets ratios.⁸⁰ However, the capital ratios of most Japanese banks were far below the required minimum throughout the period.⁸¹ For instance, between fiscal years 1976 and 1985, Japanese banks' capital ratios to deposits were, on average, lower than 6 percent, hitting a low of 3.7 percent at the fiscal end of 1984 (see Figure 3.1).⁸² In fact, the MFJ had no intention of enforcing the regulation, as they thought the required minimum was too high for Japanese banks, so that the ministry did not penalise banks for noncompliance (Sawabe 2002: 404-405). Annual reports of the ministry's Banking Bureau never expressed any serious concerns or warnings about the low capital ratios of banks. They never even compared disclosed capital ratios to the regulatory minimum (Hoshi 2002: 158).

Figure 3.1 The average of capital to deposit ratios of Japanese banks, FY1974-1985
(end of fiscal year; %)



Source: Federation of Bankers Associations of Japan, various issues of *Zenkok Ginkou Zaimushyohyou Bunseki* (Analysis of Financial Statements of All Banks).

experienced about 470 bank failures between 1985 and 1987 (Singer 2004: 556).

⁷⁹ Author's interview with Nishimura Yoshimasa.

⁸⁰ Capital in the capital to deposit ratio regulation included paid-in capital, capital reserves, and other reserves.

⁸¹ Japanese banks disclosed their capital ratios publicly.

⁸² The Japanese fiscal year ends in the end of March of the following calendar year.

Note: In Japan, “major banks” include “city banks”, “long-term credit banks”, and “trust banks”; “all banks” include “major banks” and “regional banks”.

Although Japan’s financial system began to be gradually deregulated from the 1970s on, the MFJ could effectively rely on rescue mergers in preventing bank failures. As a result, the neglect of the importance of capital adequacy regulation by the MFJ continued, until the convoy system began to unravel during the mid-1990s.⁸³ Also, as long as the economy prospered and the banking system was sound (until the early 1990s), there was a social consensus in the country that the convoy system worked well and the oversight and management of the banking system was best done by the MFJ, who were perceived by the Japanese to be the best and the brightest Japanese university graduates (see Patrick 2001: 8). Consequently, around the time when the Basel Accord was established, there were few Japanese who argued for the necessity of a new capital adequacy regulation to strengthen the soundness of the banking sector.

Lowering banks’ compliance costs for common capital adequacy standards

While the Japanese did not feel the necessity to strengthen capital adequacy regulations, foreign banks regulators in major countries began to put growing emphasis upon bank capital in the 1980s. In the meantime, Japanese banks were rapidly expanding their business in foreign countries. As a result, the MFJ began to worry that Japanese banks might face pressure from foreign bank regulatory authorities to increase their capital levels. To cope with possible foreign pressure, the ministry deliberately modified their capital regulations to increase the disclosed CARs of Japanese banks, but without raising their actual capital levels.

The international trend in capital regulation and Japanese banks in the 1980s

From the early 1980s on, bank regulators in major countries—in particular, the United States and the United Kingdom—began to put great emphasis on capital adequacy. As U.S. banks’ capital levels consistently fell over the 1970s, U.S. regulatory authorities—the Federal Reserve and the Office of the Comptroller of the Currency jointly—adopted a gearing ratio approach, which related capital to total assets, in 1981 in order to halt the erosion in banks’ capital. In mid-1984, the three pillars of the U.S. regulatory

⁸³ Author’s interview with Nishimura Yoshimasa.

authorities—the Federal Reserve, the Office of the Comptroller of the Currency and the Federal Deposit Insurance Corporation—released coordinated proposals for minimum capital standards.^{84,85} After the failure of Continental Illinois, the eighth largest bank in the country, in the same year, the U.S. regulatory authorities' efforts to strengthen capital regulations intensified, and, as a consequence, they issued a joint proposal to adopt a risk-weighted capital ratio approach in January 1986 (Vernon, et al. 1991: 140-141). In the United Kingdom, capital had not been traditionally a major concern of the bank regulatory authority. However, the collapse of a number of undercapitalised banks during the 1970s made them put greater emphasis on capital. As a result, U.K. regulators adopted a capital to risk-weighted asset ratio measure in 1980 (Kapstein 1989: 338, 1992: 279).

The Basel Committee also began to monitor the CARs of leading international banks from the beginning of the 1980s. In 1982, the Committee presented a report to the central bank governors seeking their endorsement of a collective stand to take action to halt the deterioration in the levels of banks' capital, in the light of a rapid growth in their international lending. The 1982 debt crisis accelerated the debate on capital adequacy in the Committee. Furthermore, U.S. regulatory authorities began to make efforts to build a common capital adequacy framework among Committee members from 1983. As a result, the Committee constructed its first framework to compare national capital adequacy standards and the relative capital position of banks from different countries in the year, and tested the framework by applying it to a representative sample of international banks from each of Committee countries (Cooke 1990: 313-322; Reinicke 1995: 163-164).

Meanwhile, in Japan, as the internationalisation of the financial system became an important issue in the early 1980s, particularly after the U.S.-Japan Yen-Dollar Committee in 1983, the MFJ paid attention to the international trend of the increasing concern over bank capital.⁸⁶ The MFJ noted that regulatory authorities in the United

⁸⁴ The demand for strengthening banking regulations emerged in the U.S. Congress in 1983, in which U.S. bank regulatory authorities sought to increase the U.S. quota in IMF resources by approximately USD 8.4 billion in order to deal with U.S. commercial banks' weakness caused by the debt crisis (Oatley and Nabors 1998: 42). Congress blamed the regulatory authorities' failure to prevent the banks' imprudent lending, and forced them to tighten bank regulations by imposing stricter capital adequacy standards (Reinicke 1995: 143-153).

⁸⁵ Prior to the 1980s, each of the U.S. bank regulatory authorities had established its own capital regulations, and their regulations were not intended to be stricter than any of the others' (Kapstein 1992: 278).

⁸⁶ See Rosenbluth (1989: 68-89) for the Yen-Dollar Committee.

States and in the United Kingdom put a growing emphasis upon bank capital.⁸⁷ The ministry's concern about the U.S. and the U.K. bank regulations were natural because New York and London were the most important financial centres in the world and because Japanese banks were rapidly expanding their business in these countries through the 1980s.⁸⁸

In these circumstances, the MFJ began to worry that if the Japanese capital adequacy regulations were not comparable with those in major countries, it would have a negative effect on the overseas business of Japanese banks. In other words, "Japanese regulators anticipated that the neglect of capital in the Japanese regulations could provoke foreign pressures [on Japanese banks to raise their capital levels]."⁸⁹ In fact, during the 1980s, Japanese banks' CARs were at the lowest level among Basel Committee countries in terms of the capital to asset ratio (see Oatley and Nabors 1998: 47-48), while their market share in the international lending market was rapidly increasing.⁹⁰ As a result, Japanese banks were facing heavy criticism from their U.S. and European competitors, who were accusing them of raising their international market share by taking advantage of the domestic regulations which allowed them to hold a lower capital level (Kapstein 1992: 277).

The new capital adequacy regulations of 1986

Even though the MFJ strongly believed that Japanese banks did not need to hold more capital, the international trend of strengthening bank capital led the ministry to embark on modifying the bank capital regulations in order to cope with potential foreign pressure. Accordingly, this modification of the capital regulations was deliberately carried out in such a way as to balance two different goals: to bring the regulations more in line with those in major countries, but not to increase the actual capital levels that Japanese banks had to hold. The Financial System Research Council, which was an advisory body to the MFJ, was responsible for the task of designing new capital regulations.⁹¹

⁸⁷ Author's interview with Nishimura Yoshimasa.

⁸⁸ This issue will be discussed in detail in the next chapter.

⁸⁹ Author's interview with Nishimura Yoshimasa.

⁹⁰ This issue will be discussed in detail in the next chapter.

⁹¹ The council consisted of senior business, financial industry representatives and others. However, the ministry's Banking Bureau officials also attended in the council as advisors, and MFJ officials played key roles in screening potential members, setting agendas, and conducting meetings (Tamura 2003a: ch. 4).

The Council made a suggestion in the second interim report of *The Present Situation of Financial Liberalisation and Its Management* of June 1984 that it would be desirable to change the then capital to deposit ratio regulation for the overseas business of Japanese banks (MFJ 1984: 359-364). In its final report of 1985, the Council provided a specific framework for the change. In the framework, the capital to deposit ratio regulation was replaced by the capital to total asset ratio regulation, and a part of unrealised gains on share holdings was included in the regulatory capital (MFJ 1985: 338-343). Based on the framework, the MFJ issued a new administrative guidance on bank capital adequacy in May 1986 (MFJ 1986: 36-38).⁹²

The MFJ clearly expressed that the new capital adequacy regulations reflected the international trend of strengthening capital adequacy and the foreign criticism of the lax Japanese capital adequacy regulations (see MFJ 1986: 32). Also, during later negotiations with the United States and the United Kingdom for a common capital regulatory framework in 1987, a MFJ official commented:

There are criticisms on the behaviour of Japanese banks overseas, ... With those backgrounds, the last year's amendment of the balance sheet regulation on banks [the 1986 capital adequacy regulations] was one of our steps to build a regulatory standard which can stand against the criticism from overseas (recited from Sawabe 2002: n. 48).

The new regulations employed regulatory elements that were generally accepted by Basel Committee countries at the time. The previous capital to deposit ratio regulation was replaced by a capital to asset ratio regulation, which was a rule employed by a number of Basel Committee countries (the United States, Canada, Italy, and Luxembourg).⁹³ Some off-balance-sheet transactions were included in assets. Special loan loss provisions were not counted as capital. Also, the calculation method of the amount of total assets was changed from the term-end balance to the term-average balance in order to increase the reliability of CARs (MFJ 1986: 33-34).

However, the new capital adequacy framework was designed to raise disclosed CAR without increasing Japanese banks' costs to comply with the regulations. The capital framework employed two different minimum CARs. While all banks had to maintain

⁹² In March 1985, the MFJ allowed banks to issue foreign currency denominated convertible bonds in overseas markets, which was expected to help banks increase their capital bases (MFJ 1985: 34).

⁹³ Most European countries in the Basel Committee used capital to risk-weighted asset ratio approaches (Cooke 1990: 314).

their CARs above only 4 percent from 1990 on, only international banks, which referred to banks with overseas branches, were required to maintain their CARs over 6 percent from 1987 on. The higher minimum CAR requirement of 6 percent for international banks was intended to reduce the foreign criticism of the low capital levels of Japanese banks.⁹⁴ Yet, the MFJ allowed international banks to include 70 percent of unrealised gains on share holdings in the regulatory capital.⁹⁵ Also, the new capital framework allowed banks to include tax effects in relation to provisions and depreciations in the regulatory capital (MFJ 1986: 33-35).

The inclusion of 70 percent of unrealised gains on share holdings in the regulatory capital was a deliberate effort on the part of the MFJ to help Japanese banks with overseas branches to meet capital adequacy standards in major countries. In fact, the inclusion of unrealised gains on share holdings in the regulatory capital could have been a problem from the perspective of prudential regulation during both economic booms and economic downturns (Sawabe 2002: 410-412).⁹⁶ However, the required minimum CARs in major countries were generally higher than the capital level of Japanese banks; for instance, U.S. regulations had required banks to maintain their CARs over 5.5 percent since 1985 (Reinicke 1995: 150), which was almost double of the Japanese banks' capital level of about 3 percent. Meanwhile, Japanese banks traditionally had a huge amount of unrealised gains on securities holdings. In these circumstances, the MFJ concluded that without the inclusion of unrealised gains on share holdings it was impossible for Japanese banks to increase their CARs to a level that foreign regulators might require them to hold.⁹⁷

Highlighting the inclusion of 70 percent of unrealised gains on share holdings, Tamura (2003a: ch. 4) argues that the 1986 capital framework was the failure of MFJ's efforts to strengthen the Japanese capital adequacy regulations due to Japanese banks' opposition.⁹⁸ However, although it was Japanese bankers who provided the idea of

⁹⁴ The MFJ emphasised that the 6 percent regulation was necessary to cope with the international trend of strengthening capital adequacy regulations (see MFJ 1986: 33-35).

⁹⁵ The figure of 70 percent was decided based on past fluctuations of stock prices (MFJ 1986: 35).

⁹⁶ In a bull market, banks' unrealised gains on securities holdings and in turn their CARs could be inflated so that the capital adequacy rule could fail to induce the banks to behave prudently; meanwhile, in an economic down, banks' unrealised gains and CARs could contract along with declining stock prices and, as a result, the inclusion of the unrealised gains in the regulatory capital could threaten the soundness the banks (Sawabe 2002: 410-412). However, note that at that time the Japanese regulatory authority expected that the country's economy and stock market would continue to grow.

⁹⁷ Author's interview with Nishimura Yoshimasa.

⁹⁸ Tamura (2003a: ch.4) also indicated that the 1986 administrative guidance on capital

including unrealised gains on share holdings in the regulatory capital, the MFJ agreed to it without opposition.⁹⁹ In fact, Japanese banks did not like the idea of showing their unrealised gains, which had been formally invisible on their balance sheets, because it would reduce their managerial freedom (Sawabe 2002: 412-415). When the MFJ later negotiated with foreign bank regulators for the establishment of a common capital adequacy framework (the Basel Accord), the ministry tried to bring the common capital framework close to the 1986 capital regulations in order to protect the competitiveness of Japanese banks.¹⁰⁰

Summary

The Japanese bank regulatory authority, the MFJ, maintained the convoy system in administering the country's banking system. The convoy system provided a very strong bank safety net, by not allowing any banks to fail, and it did work very well throughout the 1980s. Therefore, even though bank regulators in major countries began to put growing emphasis on bank capital adequacy from the early 1980s, the need for strengthening the capital adequacy of banks was low in Japan. However, the MFJ considered the possibility that foreign regulators might impose strict capital adequacy requirements on Japanese banks, which would have a negative effect on their international business activities. As a result, the MFJ modified the Japanese bank capital regulations to become in line with those in major countries in 1986. Nevertheless, the new capital framework did not require the banks to raise their actual capital soundness. The idea of capital adequacy regulation was alien to the Japanese until the mid-1990s, when the convoy system stopped working properly and Japanese banks began to go bankrupt.

3.2 South Korea

Korea's bank regulatory authority traditionally tended to neglect prudential regulation for banks. As a result, the BIS standard was not deemed necessary by the regulatory authority in order to strengthen the stability of the country's banking system. I will first

adequacy did not provide the MFJ with a legal means to impose the new capital standards. However, MFJ's administrative guidance had traditionally carried no legally-binding obligations, but Japanese banks complied with them in most cases.

⁹⁹ Author's interview with Nishimura Yoshimasa.

¹⁰⁰ This issue will be discussed in detail in the next chapter.

analyse the country's bank regulatory structure, which hindered the regulatory authority in developing prudential regulation. Then, I will examine the relations between the government and banks, which reduced the necessity to implement capital adequacy regulations.

The subordination of bank regulators to the Ministry of Finance

The banking regulatory institutional framework in Korea was different from those in Japan and in Taiwan. Bank regulation was carried out by finance ministries in those countries (in Japan until 1998 and in Taiwan until 2004). In contrast, Korea's bank regulatory authority, the Office of Bank Supervision (OBS), was located in the central bank, the Bank of Korea (BoK), until the establishment of the new financial regulatory authority, the Financial Supervisory Commission (FSC) in the wake of the 1997 financial crisis. However, although the OBS was legally independent from the Ministry of Finance of Korea (MFK),¹⁰¹ it was, in practice, subordinate to the ministry. This regulatory institutional framework hindered Korean bank regulators in attaching the priority to prudential regulation, including capital adequacy regulation.

Korea's supreme legal authority to govern commercial banks—"nationwide banks", "regional banks", and foreign bank branches—was the Monetary Board. The Board was composed of nine members representing various groups in the economy: the Minister of Finance (ex officio), the Governor of the BoK (ex officio), one member recommended by the Minister of Economic Planning, two members recommended by banks (the Korea Federation of Banks), two members recommended by the Minister of Agriculture, Forestry and Fisheries, and two members recommended by the Minister of Trade and Industry. The Board was responsible for the formulation and implementation of monetary credit policies and the direction and supervision of the operations, management and administration of the BoK. The Board also exerted direct control over commercial banks under the General Banking Law, regulating market entry, scope of banking business, capital adequacy, and so forth, in order to ensure prudential banking practices (OBS 1992a: 10).

The OBS was established within the BoK under the Bank of Korea Act as the bank supervisory executive branch of the Monetary Board (and also the BoK). Although the OBS was subject to instructions and direction of the Board, the authority for the bank

¹⁰¹ The ministry was reorganised to the Ministry of Finance and Economy (MoFE) in 1994 when it merged with the Economic Planning Board. MFK refers to MoFE from this point on.

regulatory administration was largely delegated to the OBS from the Board. For instance, the 1992 'Prudential Management Guidelines for Banking Institutions,' which was a broad framework of prudential regulations and which included a provision requiring banks to keep their capital to risk-weighted assets ratios—that is, BIS CARs—over 8 percent, was formally formulated by the Board. However, the OBS had a mandate to design 'Detailed Enforcement Regulations for Prudential Management Guidelines for Banking Institutions,' which included the calculation method of the Korean BIS CAR, asset classification rules, provisioning requirements, and so on. In short, the OBS had a high degree of *formal* institutional independence in formulating regulations.

The OBS carried out periodic examinations on the head offices and about 10 percent of bank branches at least once a year without prior notice, and the scope of the periodic examinations covered all activities and operation of the banks. It also conducted a special examination when a bank's situation raised imminent policy issues or there were other serious problems. The OBS reported the results of the examinations to the Board (Shim 2000: 18). Moreover, Korean banks were heavily under government control until the late 1990s, functioning as almost development institutions. The low management autonomy of the banks implied that it was almost impossible for them to oppose government policies.¹⁰² Given the relations between the government and the banks, the OBS also appeared to have a good degree of independence in supervising the banks.

In addition, although the OBS was a branch of the BoK, the OBS largely had budgetary and institutional independence from the central bank. The Governor of the BoK had the authority to control, administer and direct the business operation and management of the entire BoK. However, the BoK paid little attention to prudential regulation, focusing on the area of monetary stability rather than the area of financial stability. In addition, although the OBS was part of the BoK, the Governor could intervene in the operation of the OBS only as a member of the Monetary Board due to the control of the Board over the OBS (Shim 2000: 17-18). In actual fact, the BoK and the OBS behaved as almost separate institutions (Kim 2003: 77; NARK 1999c: 1). As a result, the OBS exercised discretionary control over its personnel management and budget (OBS 1992a: 12).

However, the OBS had, in practice, no independence from the MFK, which occupied the supreme position in the country's financial administration. Although the

¹⁰² The government control over banks will be addressed in the following section.

MFK had no legal power to govern the OBS (Shim 2000: 56), the ministry effectively controlled it. For example, the MFK exercised critical influence on the appointment of senior personnel to the OBS. The Superintendent of the OBS was appointed by the President upon the recommendation of the Monetary Board for a four-year term, and the Deputy Superintendent and Assistant Superintendents were appointed for three-year terms by the Board upon the request of the Governor of the BoK, as recommended by the Superintendent of the OBS (OBS 1992a: 12). Therefore, the Board had the power to appoint the senior personnel of the OBS. Yet, it was the MFK that effectively controlled the Board: in addition to the ex-officio membership of the Finance Minister, the ministry could recommend another member of the Board; the two Board members recommended by the Korea Federation of Banks were, in reality, appointed by the MFK;¹⁰³ accordingly, the MFK could choose a majority of the Board members (Kim 2003: 65-66).¹⁰⁴ The Superintendents of the OBS had not come from the OBS or BoK staff, but were former MFK officials. As a result, the OBS was under the direct control of the MFK, and the OBS conducted bank regulations in accordance with directions from the ministry.¹⁰⁵

It is important to note that there was generally no conflict in policy preference between the OBS and the MFK.¹⁰⁶ In practice, the OBS was not an independent bank regulatory agency with the primary goal of maintaining stability in the banking system. Instead it functioned as a branch of the MFK. The hierarchical system between the MFK and the OBS hindered the OBS in developing its own policy goals. In fact, although “prudential regulation” became a buzzword inside the OBS in the early 1990s, as a number of countries were strengthening prudential regulations, most of the staff did not understand what it actually meant.¹⁰⁷ As a result, the policy stance of the OBS in coping with the Basel Accord was in conformity with the policy of the government, especially the MFK, which administered its implementation largely within the

¹⁰³ After candidates for these two appointments had been named by the Finance Minister, the staff of the Board obtained signatures on the nomination forms from the members of the Korea Federation of Banks (Kim 2003: 65-66).

¹⁰⁴ Also, the Finance Minister had the casting vote on resolutions of the Board, in his capacity as the Chairperson. In addition, the minister had the power to request the Board to reconsider resolutions already adopted. As there was no limit to the power to request reconsideration, the minister could exercise the power whenever she or he disagreed with a resolution of the Board. When the minister made a request of reconsideration, the Board was bound to review its position (Shim 2000: 17).

¹⁰⁵ Author’s confidential interview with a senior MoFE official, Seoul, 21 February 2005.

¹⁰⁶ Author’s confidential interview with a senior FSS official, Seoul, 31 January 2005.

¹⁰⁷ Author’s confidential interview with a FSS official, Seoul, 15 February 2005.

framework of the ministry's macroeconomic policy framework.¹⁰⁸

The Ministry of Finance and the role of banks in Korea's economic development

The MFK held the highest authority in all areas of the country's financial administration, including regulatory and monetary affairs, until the establishment of the FSC and the independence of the BoK in the wake of the 1997 financial crisis.¹⁰⁹ In addition to effective control over OBS, which regulated commercial banks, the MFK directly supervised specialised banks.¹¹⁰ The ministry was responsible for drafting and presenting banking regulatory bills to the National Assembly (the legislature), and it had the power to issue ministerial decrees. The ministry was also responsible for the supervision of non-bank financial institutions such as development institutions, savings institutions, securities institutions, and life insurance institutions. Although securities firms and insurance firms were also supervised by the Securities Supervisory Board and the Insurance Supervisory Board, respectively, the Boards were under the control of the MFK (OBS 1992a: 8). In addition, the ministry held a prominent position over the central bank by holding supervisory authority over the business of the BoK.¹¹¹ As a result, the MFK had control over monetary policies (Shim 2000: 18-19, 39).

In administering financial policies, the key objective of the MFK—that is, the government—was historically economic growth.¹¹² The priority on growth was, in part, related to the weak legitimacy of the authoritarian regimes from the 1960s to the 1980s. The Park Chung Hee administration (1961-79) and the Chun Doo Hwan administration (1980-88) took the power by a military coup, and, as a result, the political legitimacy of their administrations was fragile.¹¹³ Therefore, they put the pre-eminent emphasis on rapid economic growth in order to justify their ruling, often sacrificing economic

¹⁰⁸ This issue will be discussed in detail in Chapter 6.

¹⁰⁹ The MFK continued to exercise a strong influence in regulatory policies despite the presence of the FSC during the late 1990s and early 2000s. This issue will be discussed in Chapter 6.

¹¹⁰ The OBS had the legal authority to examine some of specialised banks, such as the National Agricultural Cooperative Federation, the National Federation of Fisheries Cooperatives and the National Livestock Cooperatives Federation (OBS 1992a: 7), while the MFK supervised trust accounts in commercial banks in accordance of the Trust Business Act, although their banking accounts were regulated by the OBS (Kim 2003: 72).

¹¹¹ The MFK had the responsibility to approve amendments of the Bank of Korea Act, received the statement of accounts of the BoK, appointed the auditor of the BoK, and examined the business of the BoK (Shim 2000: 18-19, 39). See also Kim (2003: 56-90).

¹¹² See also Kim (2003).

¹¹³ The political legitimacy of President Rho Tae-Woo (1988-93), who was another former military general and close friend of Chun Doo Hwan, was also not high.

stability for the sake of growth, in contrast to the Taiwanese government (Cho and Kim 1997: 27-28, 52-54).¹¹⁴

The MFK controlled financial institutions tightly in driving economic growth. When the government embarked on the industrialisation of the country in the early 1960s, they wanted to control the behaviour of industrialists in order to make their economic activities conform to the “national interest.” The major policy instrument for the government to use in order to direct firms’ behaviours was control over finance. Commercial banks were nationalised in 1961, and the BoK was relegated to the status of a virtual rubber stamp for MFK decisions and served as a ready source of government debt financing by the amendment of the Bank of Korea Act in 1962 (Cho and Kim 1997: 3, 22, 34; Choi 1993: 26-27; Kim 2003: 64-70). Although the commercial banks were re-privatised in the early 1980s, the MFK continued to exercise a strong influence over their management, including the appointment of top managers and even the day-to-day management, through administrative guidance and moral suasion until the late 1990s (Park and Kim 1994: 192). As a result, credit policy was formulated by the MFK as part of the development strategy, and its effectiveness was determined within the overall structure of the ministry’s industrial and macroeconomic policy (Cho and Kim 1997: 30-47; Choi 1993).

In the suppressed financial system, Korean banks functioned almost as a treasury unit of the government to support its financial policies. Policy loans were a typical example. One type of policy loans was explicitly earmarked credit programmes, such as those for exports, agriculture, fisheries or SMEs, in which borrowers received loans at preferential rates. Although the amount of these policy loans declined over time, they accounted for about 30 percent of total credit available in the economy in the 1980s. Banks (including specialised banks) financed about 62 percent of the policy loans between 1973 and 1991. However, banks had no voice in the allocation of policy loans of this kind and had to accommodate these loans irrespective of their portfolio strategies.¹¹⁵ The other type of policy loans was loans allocated through government directive, administrative guidance or ad hoc interventions. Their lending conditions were the same as those of general bank loans. Yet, as real interest rates were negative, the allocation of bank credit itself was a great favour. Although it is not possible to

¹¹⁴ Calls for controlling inflation were usually overshadowed by the MFK’s growth-oriented development strategy, in which the central bank financed various credit programmes and the government’s expansionary fiscal policies (Cho and Kim 1997: 27-28, 52-54).

¹¹⁵ There were some 221 types of policy loans of the kind among a total of 298 types of bank loans in 1981 (Woo-Cumings 1997: 63).

estimate the exact amount of this type of policy loan, it seems to have been substantial (Cho and Kim 1997: 48-51; Woo-Cumings 1997: 63).

Banks financed their policy loans partly through government support. From 1973 to 1991, about 35 percent of the first type of policy loans made by banks were financed by central bank credit. Although the share of the banks' policy loans supported by the central bank declined over time, about 27 percent of such policy loans were still financed by the BoK. Also, it should be noted that Korean banks heavily depended on the central bank in mobilising funds available for loan in general. For instance, between 1981 and 1990, the annual average ratios of central bank discount loans to total bank loans in the country amounted to about 23 percent, compared to about 2 percent in Japan and about 9 percent in Taiwan during the same period (Cho and Kim 1997: 52-54). This funding practice of Korean banks reflected the close relations between the government and the banks.

Government's protection of banks and weak prudential regulation

In return for financial repression, the government provided strong protection from failure for banks. The government did not allow any banks to go bankrupt, partly using the central bank as the lender of last resort for Korean banks in a broad sense. For instance, there was the BoK Special Loan, which was introduced in 1972, and remained until 1982. There were two types of the Special Loans available to commercial banks in the 1972 system: B1 and A1. The BoK supplied B1 loans for banks when they had difficulty maintaining the reserve requirement due to "relief lending" to insolvent firms in order to ensure the banks' liquidity. A1 loans were used in liquidating insolvent companies. Also, in 1985, the government forced the BoK to introduce and lend new special loans, which were termed A2 loans, to banks at an annual interest rate of 3 percent, in order to reduce the financial pressure on the banks facing a growing amount of NPLs (Shim 2000: 48-49).¹¹⁶ Indeed, the country did not experience the failure of

¹¹⁶ The process of the government rescue of troubled banks was not transparent. In accordance with the order of the MFK, a special section of the BoK, supporting its lender of last resort function, did not disclose information about insolvent banks to the Monetary Board or to other parts of the central bank. The information was kept secret by the MFK, which decided the operation of special loans and then requested that the Board to issue them. Special loans were made without the knowledge of the market and they carried no penalty charge. As a result, banks even sought to receive special loans. In fact, some BoK officials sarcastically referred to the lender of last resort function of the BoK as "the lender of first resort function" (Kim 2003: 171-172).

any financial institutions, including small and mutual savings and finance companies, until the 1997 financial crisis (Song 1998: 11).

In the presence of the strong government protection of banks, they did not pay much attention to risk management, carrying a huge amount of NPLs. During the 1960 and the 1970s, the ratio of NPLs to total credit in nationwide banks was at a manageable level of about 3 percent.¹¹⁷ However, the ratio drastically rose during the 1980s, as the financial system began to be liberalised, long covered-up NPLs were disclosed all at once, and industrial restructuring was carried out by the government. The ratio rose from 2.7 percent in 1980 to 7.3 percent in the following year, and it reached a scary double digit height of 10.5 percent in 1986.¹¹⁸ Meanwhile, the capital level of Korean banks was not high. During the early 1970s, the ratio of net worth to total assets in nationwide banks was below 4 percent. The ratio rose to 5.9 percent by 1979, but it then proceeded to fall until the late 1980s, when the banks offered a massive amount of stocks in the rising stock market, dropping to 3.8 percent in 1985 (Kim 1994: 302-310). At the end of 1984, according to an estimate by the BoK, NPLs in nationwide banks were 2.6 times as high as their total net worth (Park and Kim 1994: 209).

However, neither the MFK nor the OBS paid much attention to strengthening capital adequacy regulations for banks because they did not allow the banks to fail.¹¹⁹

Although there were capital adequacy regulations prior to the implementation of the BIS standard, they were not enforced by the bank regulators. In 1979, the OBS introduced a capital to deposit ratio guideline, which required banks to maintain their ratios above 10 percent (OBS 1994c: 106-107). In 1988, the capital regulation was replaced by capital to total asset ratio regulations.¹²⁰ The required minimum capital ratios were 6 percent for nationwide banks and 8 percent for regional banks. The ratios were raised to 8 and 9 percent respectively in 1991 in order to cope with the implementation of the BIS standard in Basel Committee countries from 1992.¹²¹ However, the ratios for a large proportion of Korea banks—particularly, nationwide

¹¹⁷ NPLs consisted of only “doubtful”, and “estimated loss” loans for the period prior to 1976, but “fixed” loans were included to NPLs from the year (Kim 1994: 305).

¹¹⁸ The ratio began to fall in 1987 and dropped to 5.9 percent in 1989 (Kim 1994: 305).

¹¹⁹ Author’s confidential interview with a former senior OBS official, Seoul, 3 February 2005.

¹²⁰ The implementation of the 1988 regulations was not related to the establishment of the Basel Accord (author’s confidential interview with a senior FSS official, Seoul, 28 January 2005). One possible explanation of the change may be that the Korean regulatory authority intended to modernise their bank supervisory system by adopting the new Japanese capital regulations (the 1986 capital regulations), given that Korean bureaucrats adopted the Japanese economic model until the 1997 financial crisis.

¹²¹ Author’s confidential interview with a senior FSS official, Seoul, 28 January 2005. See also OBS (1990a).

banks—were lower than the required minimums throughout most of the period. Half of the nationwide banks did not meet the required 6 percent minimum at the end of 1988. The ratios of the banks rose in 1989, but they dropped in 1991 and all five major nationwide banks failed to comply with the required minimum ratio of 8 percent (see Table 3.1). Nevertheless, the OBS did not penalise banks for compliance failure (Shim 2000: 107).

Table 3.1 Capital to total asset ratios of Korean banks, 1987-1991
(end of period; %)

| | 1987 | 1988 | 1989 | 1990 | 1991 |
|----------------------------------------|------|------|------|------|------|
| Cho Hung Bank | 4.7 | 5.7 | 9.1 | 7.4 | 7.0 |
| The Commercial Bank of Korea | 4.7 | 5.7 | 8.6 | 7.2 | 6.8 |
| Korea First Bank | 5.0 | 5.9 | 9.8 | 8.0 | 7.7 |
| Hanil Bank | 5.1 | 6.2 | 10.0 | 8.5 | 7.9 |
| Bank of Seoul | 4.7 | 6.0 | 9.1 | 7.7 | 7.5 |
| Average of five major nationwide banks | 4.8 | 5.9 | 9.3 | 7.7 | 7.4 |
| Korea Exchange Bank | 5.4 | 5.7 | 5.7 | 5.3 | 6.3 |
| Shinhan Bank | 5.4 | 6.9 | 17.2 | 18.7 | 12.9 |
| KorAm Bank | 4.4 | 6.1 | 14.5 | 10.5 | 8.9 |
| Donghwa Bank | - | - | 21.6 | 19.9 | 15.2 |
| Dong Nam Bank | - | - | 21.8 | 17.3 | 12.3 |
| Dae Dong Bank | - | - | 27.7 | 19.4 | 13.1 |
| Hana Bank | - | - | - | - | 20.8 |
| Boram Bank | - | - | - | - | 17.5 |
| Average of all nationwide banks | 4.8 | 6.0 | 9.5 | 8.5 | 8.2 |
| Daegu Bank | 4.7 | 8.5 | 15.4 | 11.9 | 10.4 |
| Pusan Bank | 4.8 | 7.5 | 9.8 | 8.0 | 7.9 |
| Chung Chong Bank | 7.1 | 11.1 | 15.8 | 12.4 | 11.2 |
| Kwangju Bank | 7.8 | 11.8 | 19.2 | 14.3 | 14.4 |
| Bank of Cheju | 9.0 | 10.6 | 17.1 | 14.7 | 13.7 |
| Kyungki Bank | 7.3 | 12.0 | 17.3 | 13.0 | 11.4 |
| Jeonbuk Bank | 9.7 | 22.4 | 27.5 | 22.9 | 18.9 |
| Kangwon Bank | 14.0 | 20.6 | 24.2 | 18.7 | 13.6 |
| Kyongnam Bank | 4.7 | 10.4 | 16.1 | 12.5 | 11.1 |
| Chungbuk Bank | 5.0 | 16.5 | 21.9 | 18.5 | 14.1 |
| Average of all regional banks | 6.1 | 11.4 | 16.5 | 13.0 | 11.6 |
| Average of all banks | 5.0 | 6.8 | 10.5 | 9.1 | 8.7 |

Source: Office of Bank Supervision, various issues of *Unhaeng Gyeongyeong Tonggye* (Bank Statistics).

Likewise, the MFK and the OBS had little intention of using the BIS standard in order to strengthen the domestic capital regulation. As in Japan, in the presence of the “no bank failure” policy of the government, the BIS standard, which was a regulation to prevent bank failure, could not make much of an impression among Koreans.¹²² Song Inwon (1998: 11), who was a former Deputy Director of OBS, wrote:

... Korea has provided financial institutions with an implicit safety net by its continued policy stance of not allowing any financial institutions to fail. ... In this environment, prudential supervision measures were long seen as not very important.

Few people in the country—and also a number of foreign observers—saw the failure of Korean banks as likely irrespective of capital adequacy (Park and Kim 1994: 217), until they witnessed the closure of banks in the wake of the 1997 financial crisis. The incentives for the regulatory authority to adopt the BIS standard came from the outside, which will be discussed in the following chapter.

Summary

The OBS was Korea’s bank regulatory agency. However, even though the OBS had a good degree of formal independence, it was in practice subordinate to the government, especially the MFK. As a result, the OBS did not develop its own policy goals to promote financial stability or prudential regulation. Meanwhile, the primary goal of the Korean government in economic development was growth. To achieve the goal, the government repressed the banking sector, using banks as a tool to mobilise and allocate credit according to the government’s economic policy. In return, the government provided the banks with strong protection against insolvency. In these circumstances, capital adequacy regulations to prevent bank failures and prudential regulation in general did not attract much attention in the country until the outbreak of the 1997 financial crisis.

3.3 Taiwan

Taiwan’s bank regulatory authority, like their Japanese and Korean counterparts, did not

¹²² Author’s confidential interviews with senior FSS officials, Seoul, 31 January 2005 and 15, 16 February 2005.

take heed of the capital adequacy of Taiwanese banks until the late 1980s. While the Taiwanese government traditionally put a great emphasis on financial stability, this emphasis on financial stability led the government to build a banking system in which the necessity of capital adequacy regulations was not high. However, the domestic need to strengthen the country's capital adequacy regulation emerged in the late 1980s. This provided an incentive for the regulatory authority to adopt the BIS standard as a means to ensure stability in the banking system.

Priority for stability

Pursuant to the Banking Law, the Ministry of Finance of Taiwan (MFT) was the primary authority of administrative regulation and operational supervision of the financial system in Taiwan. The ministry had authority in the areas of issuing and revoking a banking license, regulating minimum capital and business items, granting permission to merge or reorganise a bank and establish a branch, and determining penalties for violations of the Banking Law. Also, the ministry could, at any time, require banks to submit financial statements for examination. These responsibilities of the ministry were mainly conducted by its Department of Monetary Affairs, which was reorganised as the Bureau of Monetary Affairs (BoMA) in order to meet the regulatory need caused by financial liberalisation in July 1991.¹²³ Meanwhile, the central bank, the Central Bank of China (CBC), was in charge of controlling the money supply, foreign exchange and a portion of the operational supervision of the financial system (BoMA 1992: 31-36).

As it was in the case of Korea, the MFT—in other words, the *Kuomintang* (KMT) government, which governed the country for five decades until 2000—maintained a strong control over the financial sector in order to administer the country's economic development. The government directed the allocation of credit through government-owned commercial banks and specialised banks. Interest rates were controlled until 1989, when they were totally liberalised. Tight foreign exchange controls were in place (Shea and Yang 1994: 220-228; Wade 1990: 165-172). The degree of financial control in Taiwan was less severe than in Korea but greater than in Japan, and its form was different from Korea's. Nevertheless, financial control was crucial to the country's economic development, as it was in Korea (Cheng 1993: 56-57; Johnson 1987: 149; Patrick 1994; Wade 1990: 165-172).

¹²³ When the Financial Supervision Commission, the new financial supervisory authority, was established in July 2004, the BoMA became a subordinate agency to the Commission.

However, whereas the Korea government placed the top priority on growth during the country's economic development, the Taiwanese government put more emphasis on monetary and financial stability than growth when these two goals conflicted (see Cheng 1994: 163).¹²⁴ The overriding concern of the Taiwanese government for economic stability was deeply rooted in their perception that the hyperinflation and currency crisis during the civil war period (1946-49) in the mainland was a primary cause for their defeat by the Communists in 1949 (Cheng 1993: 57-58; Ho and Lee 2001: 73). In addition, the isolated diplomatic position of Taiwan made the government very cautious about financial instability.¹²⁵ The country's dwindling position in international relations meant, in principle, that it could not hope for aid from international organisations or foreign countries; it should survive on the basis of self-help in a financial crisis (Chu 1999: 191; Noble and Ravenhill 2000: 102). Therefore, the government had to pay keen attention to the stability of the country's financial system.¹²⁶

In fact, the KMT government built a strong independent central bank in order to protect the country's economic stability and, also, the political security of the KMT regime. The CBC occupied the commanding heights of the country's economic bureaucracy, and its governor was regarded as the most senior economic minister.¹²⁷ Even though the formal authority in the country's financial administration was the MFT, the ministry, in practice, played secondary fiddle to the CBC in the area of banking regulation, at least until the late 1980s. Under the steering authority of the orthodox central bank, financial as well as macroeconomic stability was a primary and enduring economic policy objective in Taiwan (Cheng 1993: 63; Chu 1999: 189-193; Thurbon 2001: 251; Wade 1990: 208).

¹²⁴ Between 1960 and 1989, the annual increase of inflation was, on average, 5.4 percent in Taiwan, while the corresponding figure reached 13.8 percent in Korea (4.9 percent in Japan) during the same period (Park 1994: 5). Also, financial liberalisation was far more cautious in Taiwan than in Korea (see Thurbon 2001; Zhang 2002).

¹²⁵ Author's interview with Chen Zhan-Shen (President of CDIC), Taipei, 8 September 2004. Taiwan was forced to withdraw from the United Nations in 1971 and to sever formal diplomatic ties with Japan and other major Western countries in 1972 (Cheng 1993: 71). Also, the country lost its membership of the IMF in 1978 (Chu 1999: 191). Only twenty-nine countries (mostly mini-countries) had diplomatic relations with Taiwan in 1997 (McBeath 1998: 186).

¹²⁶ Taiwan's government built up not only a huge amount of foreign exchange reserves, but also an exceptionally large volume of oil and food reserves (Chu 1999: 191).

¹²⁷ Some Ministers of Finance were formerly Vice Governors of the CBC (Chu 1999: 189).

The state ownership of banks and the regulation of capital adequacy

The concern with economic stability and, also, the anxiety towards the rise of big indigenous capitalists led the government to restrict the private ownership of banks, along with that of major non-financial enterprises. The KMT government's memory of private banks' behaviours during the 1940s made them conclude that the private ownership of banks would have a negative effect on economic stability: during the last wartime period (1943-45), private banks improperly profited from credit allocation and took advantage of inflation and the currency reform by the government during the civil war period was not supported by financial capitalists (Cheng 1993: 77; Ho and Lee 2001: 73). Also, the sub-ethnic position of the mainlander-dominated KMT regime made them anxious about the emergence of powerful indigenous capitalists, who might someday pose a challenge to the KMT regime. The KMT government was an "alien" regime in Taiwan when it relocated to the island after its defeat on the mainland. Only 15 percent of the country's inhabitants were emigrating mainlanders, while the remaining 85 percent were native Taiwanese. However, it was difficult for the government to build a strong support base, in particular, in the urban areas, in which the Taiwanese-dominated business sector grew rapidly.¹²⁸ Therefore, the KMT government had a strong incentive to avoid the formation of big native capital (Cheng 1993: 59).

As a result, the government owned most domestic banks and strictly controlled the new entry of private banks until the 1990s, when it allowed the establishment of a large number of new private banks.¹²⁹ At the end of 1990, a total of five specialised banks and seven commercial banks, including the "big three" commercial banks (First Commercial Bank, Huan-Nan Commercial Bank, and Chang-Hwa Commercial Bank), out of a total of ten commercial banks, were owned by the government.¹³⁰ Also, in terms of asset size, government-owned banks dominated the country's financial system: the aggregate assets of commercial banks, specialised banks, the Central Trust of China and the CBC accounted for more than 62 percent of the total assets of all financial

¹²⁸ Gregory W. Noble and John Ravenhill (2000: 102) raise doubts about the argument that the government's decision not to encourage the growth of large Taiwanese enterprises reflected an ethnic split between the mainlanders-dominated government and a Taiwanese-dominated business sector.

¹²⁹ Whereas Korea privatised commercial banks in the early 1980s, there was no public discussion of the privatisation of banks in Taiwan until the mid-1980s (Wade 1990: 161).

¹³⁰ The three private commercial banks were the Overseas Chinese Commercial Bank, the Shanghai Savings and Commercial Banks, and United World Chinese Commercial Bank. The KMT government licensed these banks to draw political support from overseas Chinese and to facilitate trade with them (Cheng 1993: 65-77).

institutions in the country at the end of 1990 (BoMA 1992: 6)¹³¹ and government-owned commercial banks accounted for more than 90 percent of the total assets of all commercial banks at the end of 1991 (Semkow 1992: 37). Overshadowed by government-owned banks, private banks were on the periphery of the banking system.

The government had strong control over government-owned banks. Chairmen of the banks were mostly ex-MFT or CBC officials, and senior bank officials were appointed by the government. The government set salary scales and the annual bonuses of bank staff (Wade 1990: 161-162). Furthermore, there were serious penalties against imprudent loan making: bankers who made bad loans were required to repay them and those who could not make restitutions were jailed. Partly because of such legal punishments, the overriding concern of government-owned banks was to protect the security of their lending.¹³² As a result, they functioned like pawnshops rather than modern financial institutions, requiring very stringent collateral conditions for loans (Cheng 1993: 80; Wade 1990: 163; Yang 1994: 312-313). In making loans, the banks required collateral of about the same value as the amount of the loans and also they usually deliberately undervalued those assets.¹³³ Accordingly, banks incurred limited losses even though the borrowers defaulted (Kuo 2000: 15). The NPL ratios of Taiwanese banks were not high.¹³⁴ For specialised banks, the ratio was 6 percent in 1980, but it dropped to 2.9 percent in 1988. For government-owned banks, the ratio was 4.4 percent in 1980, and it continued to decline through the 1980s, falling to 3 percent in 1988. The ratio of private banks was not high either. It was 3.8 percent in 1980, and, although it rose to 7 percent in 1985, it dropped to 3.2 percent in 1988 (Yang 1994: 312-313).

¹³¹ The other monetary institutions—medium business banks, credit cooperative associations, and credit department of farmers' and fishermen's associations—accounted for about 19 percent of the total, while the share of non-monetary institutions—investment and trust companies, the postal savings system, insurance companies, bills finance corporations, and securities finance companies—was less than 17 percent (BoMA 1992: 6).

¹³² The information about the financial conditions of Taiwanese firms was unreliable, and this also made Taiwanese banks very conservative in making loans (Cheng 1993: 81; Wade 1990: 163).

¹³³ Requiring collateral for loans was a common practice for Japanese and Korean banks. However, the required level of collateral was the highest in Taiwan among the three countries. However, Taiwanese banks began to relax collateral conditions in the 1980s (Kuo 2000: 15).

¹³⁴ NPLs herein consisted of "bad loans", "called accounts", and "overdue loans". Overdue loans were those late in being paid. Called accounts were overdue loans that were overdue for six months or those that were overdue less than six months but their collateral was claimed by creditors. Overdue loans and called accounts were deemed bad loans when they could not be paid back or when they were overdue for two years and had been called but not paid or when their collateral was not enough to cover the balance remaining on the loans (Yang 1994: 311-312).

Yet, the government's ownership of banks meant that there was no risk of their insolvency, with the exception of the government's default, and, therefore, the country's bank regulators did not pay much attention to the capital adequacy of government-owned banks. Taiwan's bank capital adequacy regulation prior to the adoption of the BIS standard was that the volume of liabilities a bank could hold had to be lower than a certain multiplier of the amount of its net worth. This regulation was laid down in the Banking Law in 1975, and the MFT, with consultation with the CBC, could decide the multiplier (BoMA 1993b: 1500). However, there is little evidence of how the MFT carried out the capital regulation.¹³⁵ Because of limited information of the ministry's practice of the regulation, this study analyses the capital to asset ratios of Taiwanese banks. Although this is an analytic turnaround, the analysis of the ratios has the advantage of increasing the comparability of the banks' capital levels with their Japanese and Korean counterparts, whose capital to asset ratios during the 1980s are available.¹³⁶

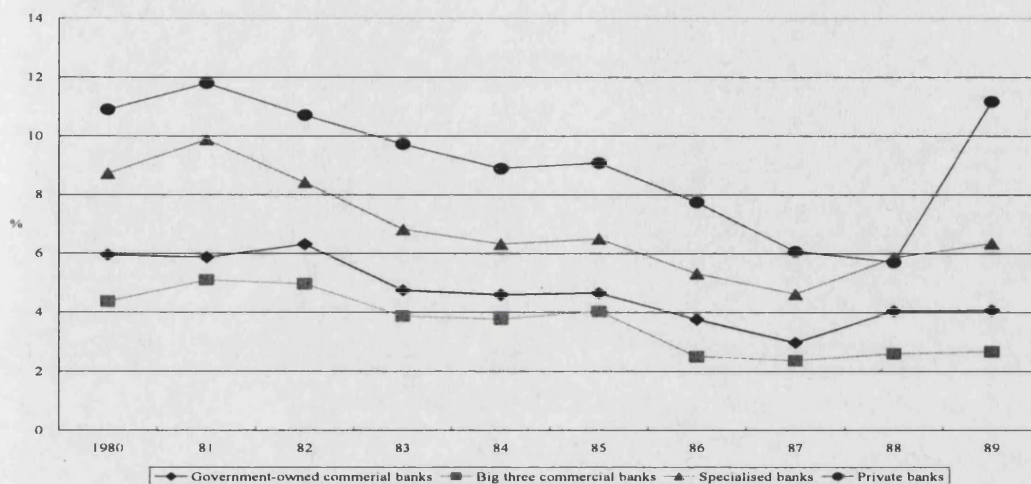
Figure 3.2 shows the average net worth to asset ratio of Taiwanese banks during the 1980s. Commercial banks, specialised banks, and medium business banks were covered.¹³⁷ Private banks' capital ratios were high, amounting to 9.2 percent on average, during the period. Although their average ratio dropped to 5.7 percent in 1988, it recovered to 11.2 percent in the following year. However, government-owned banks made a vivid contrast to the private banks. For specialised banks, the average capital ratio was 6.9 percent during the period, and the lowest was 4.7 percent in 1987. The capital ratios of government-owned commercial banks were even lower. During most of the period, their average capital ratio was barely higher than 4 percent, falling to 3 percent in 1987. The capital position of the big three commercial banks, which were government-owned, was the worst, hovering around just 2 percent on average from 1986 to 1989, while the banks accounted for more than 30 percent of total deposits in domestic banks.

¹³⁵ It may imply that the capital regulation was not, in fact, important.

¹³⁶ As discussed earlier, Japanese banks' average capital to asset ratio was about 3 percent in the mid-1980s, while the average ratio for Korean nationwide banks was about 5 percent in 1987 and about 6 percent in 1988. Yet, there is a limitation in comparing the capital levels of these banks with that of Taiwanese banks by using these ratios because the definitions of capital or assets employed in these three countries were not identical.

¹³⁷ Mutual savings and loan companies were reorganised to medium business banks in 1975. These banks dealt primarily with the supply of medium and long-term credits to SMEs (BoMA 1992: 12). There was one government-owned medium business bank and seven private medium business banks in total.

Figure 3.2 The average net worth to assets ratio of Taiwanese banks, 1980-1989
(end of period, %)



Source: Central Bank of China, various issues of *Jinron Jigou Yewu Gaikuang Nianbao* (Financial Institutions Business Operation Annual Report).

Note: 1. Assets are composed of loans and investments; 2. outliers are not included in the calculation.

This analysis of CARs of Taiwanese banks during the 1980s may imply that the Taiwanese regulatory authority adopted dual approaches in supervising capital adequacy of the banks at that time. On the one hand, the regulatory authority's traditional emphasis on financial stability might have led them to supervise the capital adequacy of private banks strictly, as their solvency was not guaranteed by the government. On the other hand, the regulatory authority may have not taken much heed of the capital adequacy of government-owned banks, as there was virtually no risk of their insolvency. Yet, even though the CARs of private banks were at a higher level than those of government-owned banks, it would be an exaggeration to argue that Taiwan had a strong tradition of capital adequacy supervision. As discussed above, private banks played a very limited role in the country's banking system. Based on the capital adequacy supervision for government-owned banks, which dominated the banking system, it would be more plausible to conclude that Taiwan's bank regulators traditionally did not put much emphasis on supervising banks' capital adequacy and that the major banks were lowly capitalised by international standards.

The domestic need for the adoption for the BIS standard

The MFT liberalised the banking sector drastically in the late 1980s, as the strong government control over the banking sector generated inefficiency in the financial system, especially during the second half of the 1980s. Government-owned banks'

ultraconservative credit allocation was unable to allocate credit effectively.¹³⁸ As a result, various forms of informal, unregulated finance expanded in the country. This resulted in a series of financial scandals in the 1980s, which culminated in the collapse of the Tenth Credit Co-op in 1985. Furthermore, the economy faced excess liquidity due to chronic trade surpluses in the mid-1980s. The excess money flooded into speculative activities in the stock market and real estate markets through informal and unregulated finance, while formal financial institutions failed to meet the credit demand in the economy. This situation threatened the stability of the financial system, and led the MFT to reform the banking sector by amending the Banking Law in 1989 (Bernard 1997: 236-238; Cheng 1993: 60, 89; Yang 1994: 292-293; Yin 2000: 141-142; Zhang 2002: 420-422).

The 1989 amendment of the Banking Law introduced various liberalisation measures. Restrictions on interest rates were totally abolished. Commercial banks were allowed to receive savings deposits while savings banks were allowed to receive checking account deposits. The disposition period of real estate or securities acquired by a commercial bank through foreclosure of mortgage was extended. The regulation of the interest rates of time savings deposits when they were withdrawn prior to the date of maturity was modified. Most of all, the MFT lifted the ban on establishing new private banks (BoMA 1993b: 1487-1645). As a result, sixteen new private commercial banks and one commercial bank reorganised from the China Trust Investment Company entered into the banking market by the end of 1993 (BoMA 1996b: 61).

As the MFT was preparing for the liberalisation of the banking sector, the ministry also planned to introduce a new capital adequacy regulation.¹³⁹ The ministry perceived that the strengthening of prudential regulations, especially, the capital adequacy regulation, was necessary due to the removal of restrictions on forming new banks (*Journal of Commerce* 9 January 1989). When the MFT was seeking a new capital adequacy regulation, the establishment of the BIS capital adequacy standard in 1988 provided the MFT with a ready-made formula. The MFT thought that the BIS standard was a capital adequacy regulation that had been developed for many years by bank regulators from advanced economies. In addition, it was difficult for the MFT to develop a new capital adequacy formula for itself.¹⁴⁰ Also, as will be discussed in detail

¹³⁸ Forty percent of bank deposits were not lent out in 1987 (Cheng 1993: 90).

¹³⁹ Author's interview with Wang Jiunn-Chih (former Director of the BoMA, President of Central Trust of China), Taipei, 1 September 2004.

¹⁴⁰ Author's interview with Wang Jiunn-Chih.

in the next chapter, the MFT perceived that the BIS standard was *the* international standard in the area of bank capital regulation and that they had to follow the international standard to avoid endangering the international business of Taiwanese banks.¹⁴¹ Although the MFT thought that the BIS standard was not the perfect capital adequacy regulation, the ministry expected that the adoption of the BIS standard would strengthen the soundness of Taiwanese banks.¹⁴²

In addition, the isolated diplomatic position of the country seemed to intensify the MFT's preference for the international standard; one reason for the MFT adopted the BIS standard was simply that it was the international standard.¹⁴³ In the late 1980s, the Taiwanese government accelerated its efforts to enhance the country's international status. Lee Teng-Hui, who assumed the presidency after Chiang Ching-Kuo's death in 1988, actively embarked on the international campaign to advance Taiwan's international position. Following his direction, the government began to make aggressive efforts to join international organisations, including an attempt to join the Asia-Pacific Economic Cooperation in 1991 (McBeath 1998: 186-187). The adoption of the BIS standard may have been expected to increase Taiwan's international image.

As a result, the BIS standard was adopted by the MFT in the 1989 amendment of the Banking Law. Article 44 of the amendment required banks to maintain their capital to risk-weighted asset ratios at no less than 8 percent. Along with the new capital adequacy regulation, the amendment also adopted several other prudential regulatory measures, such as share-holdings ceilings on single investors, the increase of the required ratio of legal reserves to net profits, the qualification for bank officials, and the protection of bank customers' private information (BoMA 1993b: 1487-1645).

Summary

Despite the emphasis upon financial stability, the government ownership of most

¹⁴¹ The most important reason why the MFT adopted the BIS standard was their concern for the international business of Taiwanese banks (author's interview with Wang Jiunn-Chih).

¹⁴² Author's interview with Wang Jiunn-Chih; author's confidential interview with a senior BoMA official, by email, 2 September 2004.

¹⁴³ Author's interview with Wang Jiunn-Chih. The Taiwanese authorities' emphasis on building a financial system coherent with international standards or best practices was consistent throughout the 1990s and the 2000s. The implementation of the 1996 amendment of the Basel Accord, the 1998 amendment of the Deposit Insurance Act, and the creation of the Financial Supervisory Commission, the new financial supervisory agency, in 2004 were driven with the catchphrase of "to be in line with international standards." Although not always successful, it was always the policy of Taiwan government to keep pace with international standards.

domestic banks made the Taiwanese bank regulators pay little attention to the capital adequacy of Taiwanese banks, especially government-owned banks, until the late 1980s. However, the domestic need for the adoption of the BIS standard emerged when the MFT allowed the entry of new private banks into the market in the late 1980s. The MFT began to seek a new capital adequacy regulation to preserve the stability of the banking sector. In this situation, the BIS standard was a ready-made option for the MFT. In addition, Taiwan's efforts to increase its international status seemed to provide an additional incentive for the regulatory authority to adopt the BIS standard, which they considered the international standard in the area of bank capital adequacy regulation.

Conclusions

The economic rationale of the Basel Accord was that banks had to maintain their capital over a certain level to prevent their failures against unexpected losses. Thus, the implementation of the BIS standard may have increased the stability of a banking system in a country where bank failures existed. To the contrary, the necessity of the capital adequacy regulation was not high in a country where the government provided a strong financial safety net so that the risk of bank failure was significantly low. In such a country, the cost of a strict capital adequacy regulation might overwhelm its benefits, by reducing the competitiveness of banks vis-à-vis foreign competitors or simply limiting the banks' operations, while making a trivial contribution to the stability of the banking system.

In Japan and Korea, the bank regulatory authorities maintained strong financial safety nets to prevent bank failures. The MFJ adopted the convoy system in which the ministry arranged a merger between a weak financial institutions and a strong one. The Korean government also did not allow any banks to fail by providing special loans to ailing banks, if necessary. These government-backed safety nets were working effectively in the late 1980s and there were no bank failures (until the mid-1990s). Accordingly, there was very little domestic need or voice to strengthen the capital adequacy regulations, and the BIS standard did not make much of an impression among the Japanese or the Koreans, including bank regulators, even though the Japanese participated in the Basel Committee. As will be discussed in the next chapter, the adoption of the BIS standard in Japan and Korea was attributable exclusively to direct or indirect external pressures.

The view of the Taiwanese regulatory authority on the BIS standard was different

from their Japanese and Korean counterparts. There was almost no risk of bank failure in Taiwan until the late 1980s, because most domestic banks were owned by the government. As a result, the MFT did not pay much attention to the capital adequacy of Taiwanese banks. However, as the MFT planned to allow the entry of new private banks in the late 1980s, the ministry felt the necessity to adopt an advanced capital adequacy regulation to supervise the liberalised banking sector. In this situation, the BIS standard was the most attractive option available to the MFT. Even though external pressure was another factor that led the ministry to adopt the BIS standard, as will be discussed in the following chapter, its adoption in the country was partly due to the Taiwanese bank regulatory authority's own need. The different motivations for adopting the BIS standard in these countries were reflected by the differences in their implementation of the BIS standard, especially during the first half of the 1990s.

CHAPTER 4

External Compliance Pressure

Why did Japan agree to establish the BIS standard and why did Korea decide to adopt it? Were there other factors that led Taiwan to adopt the BIS standard? This chapter addresses the influence of external pressures, pressure from foreign countries and pressure from the market, on the adoption and the compliance with the BIS standard by these three countries. The analysis of pressure from foreign countries begins with an analysis of the establishment of the BIS standard and the extent to which such pressure played a role in the adoption of the BIS standard by Korea and Taiwan and is followed by an analysis of whether this gave the three countries a strong incentive to comply with it. The analysis of market pressure first examines whether the BIS standard was actually accepted by the market and then shows how the bank regulatory authorities and banks perceived the market's response to the BIS standard.

4.1 Compliance pressure from foreign regulators

Pressure from major countries such as the United States and the United Kingdom was an important element in both creating the Basel Accord and maintaining compliance with the BIS standard. The idea of a common capital adequacy regulation was proposed by the United States, and the threat of market closure by the United States and the United Kingdom induced Japan to accede to create the Basel Accord. In addition, although Korea and Taiwan did not face explicit pressure from foreign countries to adopt the BIS standard, concern for their banks' business in major countries led them to adopt it as a precaution. The risk of foreign market closure remained persistent throughout the 1990s and early 2000s, and this gave the countries a strong incentive to comply with the BIS standard.

The initiation of the Basel Accord and threat of market closure

The establishment of the Basel Accord was largely a result of pressure from the United States and the United Kingdom on the other members of the Basel Committee to agree

on a common capital adequacy framework. As mentioned earlier, U.S. regulatory authorities and legislators began to make efforts to strengthen capital adequacy regulations in the country from the early 1980s. However, it was concluded at the time that improving capital adequacy regulations in a sustainable and appropriate manner necessitated an international solution. Given the global integration of financial markets, purely domestic regulatory actions could have been insufficient to protect the U.S. financial system. In addition, the unilateral strengthening of domestic capital regulations could have placed U.S. banks at a competitive disadvantage vis-à-vis foreign banks which were governed by less stringent regulations. In this situation, international regulatory harmonisation at a more stringent level provided a better solution for the U.S. government, as it could strengthen capital regulations without hurting U.S. banks' competitiveness with foreign banks (Oatley and Nabors 1998; Reinicke 1995; Singer 2004).¹⁴⁴ The U.S. strategy of targeting the international harmonisation of capital adequacy standards was reflected in the International Lending Supervisory Act of November 1983, which directed the U.S. regulatory authorities to seek an international agreement on a common capital adequacy framework in the Basel Committee (Oatley and Nabors 1998: 45; Reinicke 1995: 162-163).¹⁴⁵

Although Committee members may have agreed on the *general* need to address the capital adequacy of banks, according to Peter Cooke (1990: 324-326), the then chairman of the Committee, there was little prospect of immediate harmonisation of capital adequacy regulations at that time.¹⁴⁶ There was no consensus on the definition of capital as well as an appropriate minimum level of capital among bank regulatory authorities, who defended their own national standards in the light of differences in national banking structures and in the competitive ability of domestic banks (Kapstein 1994: 103-119; Oatley and Nabors 1998; Reinicke 1995: 162-166; Singer 2004: 546). In addition, the European Commission had been pursuing its own capital adequacy standards as part of the 1992 project, and France and several other European Community (EC) members did not want to cede regulatory leadership to the Basel

¹⁴⁴ In explaining the U.S. incentive to seek the international harmonisation of capital adequacy standards, Thomas Oatley and Robert Nabors (1998) put emphasis on the role of the legislature whereas David A. Singer (2004) stresses on the role of the U.S. regulatory authorities.

¹⁴⁵ U.S. regulatory authorities were required to report to Congress periodically on the progress towards an international agreement (Kapstein 1994: 108; Reinicke 1995: 167).

¹⁴⁶ Although the U.S. regulatory authorities' efforts to harmonise capital regulations led the Committee to establish the 1983 framework that compared capital adequacy standards, it was no more than a confidential observation framework (Cooke 1990: 324-326; Reinicke 1995: 163-164).

Committee (Kapstein 1992: 276-277). As a result, when Paul Volker, the then chairman of the Federal Reserve Board, presented the idea for convergent capital adequacy standards in Basel in 1984, his remarks were “greeted with a yawn” by central bankers (Kapstein 1994: 108). At a meeting in Basel in early 1986, central bankers commented that the introduction of standard capital requirements was unlikely (Reinicke 1995: 166).

Frustrated with the Committee’s failure to produce a common capital adequacy framework, the U.S. Federal Reserve launched a bilateral agreement on bank capital adequacy with its U.K. counterpart, the Bank of England, in January 1987. The United Kingdom joined the United States because it needed to strengthen domestic bank capital adequacy regulation, and also because it was opposed to capital adequacy standards that had been discussed in the EC (Kapstein 1992: 281;1994: 113).¹⁴⁷ The bilateral agreement set a two-tier definition of capital, adopted a risk-weighted approach, and included off-balance-sheet transactions in risk assets.¹⁴⁸ Although a minimum level of required capital was not proposed in the agreement, the U.S. and the U.K. regulatory authorities announced that they would agree on a common minimum capital level and make it public in the then near future (MFJ 1987: 40-42).¹⁴⁹

The bilateral agreement was not the result of the United States and the United Kingdom abandoning their plan to create a multilateral agreement in the Committee. Rather, the bilateral agreement was a decisive strategy to achieve a favourable multilateral agreement.¹⁵⁰ The bilateral agreement forced the other Basel Committee

¹⁴⁷ In 1984, the Bank of England provided a rescue package for Johnson Matthey Bankers, which became insolvent after it concentrated its lending to a small number of high-risk firms. This event shook U.K. voters’ confidence in the financial stability of banks, and U.K. bank regulators were ignominiously summoned to Parliament to discuss their role leading up to the insolvency of the bank (Singer 2004: 556-557).

¹⁴⁸ The bilateral capital adequacy framework divided risk-weights into five categories (0, 10, 25, 50, and 100 percent) (MFJ 1987: 40-42).

¹⁴⁹ As the negotiations between the United States and the United Kingdom for the bilateral agreement were conducted in great secrecy, the bilateral agreement shocked other bank regulators (Vernon, et al. 1991: 129). The bilateral agreement was regarded, at least at first sight, to be potentially counter-productive to the multilateral developments in the Basel Committee (Cooke 1990: 325).

¹⁵⁰ In the early February 1987, Robin Leigh-Pemberton, Governor of the Bank of England, commented: “The most important thing is that we should make an early start to widen the convergence initiative. ... We recognise that international convergence cannot be fully or properly launched in just two centres, and I do very much hope that what we have done will rapidly be followed by other authorities—notably the Japanese and our partners in Europe” (*The Times* 3 February 1987). See also Kapstein (1989: 340), Oatley and Nabors (1998: 50), Reinicke (1995: 170), Singer (2004: 546, 557), and Vernon, Spar, and Tobin (1991: 146). In fact, the bilateral agreement specified that if the Committee did not reach a prompt agreement, the U.S. and the U.K. would implement the bilateral agreement from May 1987; yet, they delayed the implementation for a multilateral agreement in the Committee (Reinicke 1995: 168, 173).

members to seek a multilateral capital adequacy agreement, by creating, in Ethan B. Kapstein's (1994: 106) words, a "zone of exclusion." The bilateral agreement posed a threat to Committee members since the international activities of their own banks would be reduced if they did not adopt a new broadly equivalent capital standard.¹⁵¹ Given the financial market power of New York and London, the threat of market closure put substantial pressure on the Committee members to move to seek a multilateral agreement (Kapstein 1989: 340-341, 1992: 282; Oatley and Nabors 1998: 50).¹⁵²

It was particularly important for the United States and the United Kingdom to ensure the adoption by Japan of equivalent capital adequacy standards, as their banks faced growing competition throughout the 1980s from Japanese banks, whose capital levels were at the lowest level among banks from Committee countries. Nine out of the world's top ten banks in terms of asset size were Japanese by 1989. More importantly, the expansion of Japanese banks in the U.S. and U.K. markets was remarkable during the period. For example, the assets of the U.S. branches of Japanese banks increased 315 percent between 1981 and 1988, while those in the U.K. rose 232 percent. By 1988, about 20 percent of the total assets of Japanese banks were held in the two countries (Terrell, et al. 1990). Japanese banks dominated the assets of the U.S. branches (and agencies) of foreign banks throughout the 1980s, increasing their share to nearly 60 percent by 1988 (Haupt 1999: 611). Japanese banks also had the largest foreign banking presence in London, with about a 15 percent share of sterling deposits by the mid-1980s (Rosenbluth 1989: 76-77).¹⁵³ In 1985, international lending by Japanese banks was greater than that by U.S. banks for the first time (Singer 2004: 554). As a result, U.S. and U.K. banks contested that Japanese banks were taking advantage of low capital adequacy levels to raise their international market share (Kapstein 1992: 277).

The United States and the United Kingdom put explicit pressure on Japan to join a common capital adequacy framework. On the day when the bilateral agreement was launched, U.S. regulators announced that they hoped that it would be a model for bank regulators of other countries, particularly Japan (*Financial Times* 8 January 1987).¹⁵⁴

¹⁵¹ In early 1987, Volcker announced that the United States would apply the bilateral agreement to foreign banks seeking expansion in the country (Oatley and Nabors 1998: 50).

¹⁵² The MFJ (1988: 34) reported that the bilateral agreement forced the Committee to begin to work for a common capital adequacy framework in earnest.

¹⁵³ Japanese banks' share of Euro deposits in London financial markets, the centre of Euro transactions, rose rapidly during the 1980s. By 1982, Japanese banks had surpassed U.S. banks in London Euro deposits, and began to account for the largest single share in the market, reaching 40 percent in 1988 (EPA 1988: 167-169).

¹⁵⁴ In fact, the President of the Federal Reserve Bank of New York, who was in Tokyo on the

The head of banking supervision at the Bank of England also commented: "If I were a Japanese banker or bank supervisor I would be a little worried about being thought to be lagging behind," and added: "I would be very disappointed if this initiative were to founder on a negative reaction from the Japanese" (Reinicke 1995: 169). Also, Gerald Corrigan, President of the Federal Reserve Bank of New York, stated in the U.S. Senate Budget Committee in May 1987: "While the areas mentioned above are important, the single item on which I place great emphasis relates to bank capital adequacy standards and specifically to the goal of moving Japanese bank capital standard into closer alignment with emerging international standards" (*The American Banker* 30 July 1987).

Indeed, the threat of market closure to Japanese banks materialised when the Federal Reserve Bank of New York required five Japanese banks (Yasuda Trust & Banking, Sumitomo Trust & Banking, Norinchukin Bank, Bank of Tokyo, and Toyo Trust & Banking) which applied to set up subsidiaries or expand their operations to provide data in line with the rules in the bilateral agreement in early February 1987.¹⁵⁵ The Federal Reserve Bank of New York announced that they needed the data to complete a review of the banks' applications (*The American Banker* 12 March 1987; *Financial Times* 21 May 1987). Two Japanese banks (Mitsui Trust & Banking and Taiyo Kobe Bank), which had submitted applications to set up trust offshoots in New York in May 1987 and in June 1987 respectively, were also required by the Federal Reserve Bank of New York to provide information about their capital ratios. In addition, the Federal Reserve Bank of New York withheld approval of another Japanese bank's (Long-Term Credit Bank of Japan) application to buy a stake in Greenwich Capital Markets, a U.S. primary dealer, by commenting: "the political environment was not right" (*The American Banker* 12 March 1987; Murphy 1988).

The timing of the information requirements by the U.S. bank regulatory authorities and their inquiry of Japanese banks' capital adequacy clearly reflected their intention to bring Japan into negotiations for a common capital adequacy framework. In fact, under the U.S. banking laws, if a bank decided to establish new operations or activities through internal growth without making a new acquisition, the U.S. regulatory authorities used to require merely that it receive prior notice where the new activities

day, attempted to put informal pressure on the Japanese to fall into line with the bilateral agreement (*Financial Times* 17 March 1987).

¹⁵⁵ The required data included the banks' unrealised gains on securities holdings, which the bilateral agreement did not include in the definition of regulatory capital and which were not required to be reported to the Japanese Finance Ministry at that time (*The American Banker* 12 March 1987; *Financial Times* 21 May 1987).

were in a traditional line of bank business. In general, such applications were processed by the U.S. regulatory authorities within thirty days on pro forma basis (*Legal Times* 8 June 1987). After all, the U.S. authority's extraordinary scrutiny of the Japanese banks' capital bases was an apparent economic sanction to bring Japan into line. Indeed, approval of the Japanese banks' applications was frozen until Japan agreed with the United States and the United Kingdom to establish a common capital adequacy framework.

Japan's agreement on the establishment of the Basel Accord

The threat of market closure generated by the bilateral agreement forced Japanese banks to change their behaviour; they began to raise their CARs. An official at the Federation of Bankers Associations of Japan (FBAJ) commented:

Without one bank failure in recent history, our attitude is why change a successful system? At the same time, we know that if we do not comply, the friction between Japan and the West will get even hotter, and we will have a hard time doing business in New York and London. (*The American Banker* 24 June 1987)

Led by the Industrial Bank of Japan in June 1987, ten major Japanese banks announced plans to raise, in aggregate, capital to the value of USD 7 billion or more in the following couple of months through convertible bonds and right issues. Some banks also planned to reduce their assets, principally poorly performing ones.¹⁵⁶ The minimum target CAR of Japanese banks of 5.5 percent, the required minimum primary capital to total assets ratio required under the U.S. regulations, reflected the Japanese banks' fear of market closure by the United States.¹⁵⁷ The MFJ helped them raise their CARs, for example, by lifting a ban on issuing convertible bonds in domestic capital markets in April 1987 (MFJ 1987: 39).

In the meantime, the MFJ entered into negotiations for a common capital adequacy framework with the U.S. and U.K. counterparts.¹⁵⁸ As discussed earlier, the MFJ had

¹⁵⁶ See *Financial Times* (8 July 1987), *International Banking Report* (17 July 1987), *Jiji Press* (12 June 1987, 28 July 1987), *Japan Economic Journal* (15 August 1987), *Japan Economic Newswire* (17 July 1987a), *Journal of Commerce* (22 June 1987), *The Guardian* (13 June 1987), and *United Press International* (19 August 1987).

¹⁵⁷ The required minimum capital to total assets ratio was 6 percent (MFJ 1987).

¹⁵⁸ In January 1987, right after the announcement of the bilateral agreement, the three countries agreed to hold talks to formulate a common capital regulation framework (*Jiji Press* 9 January

little desire to strengthen the domestic capital adequacy regulations. The attitude of the MFJ did not change despite the bilateral agreement. Indeed, when Japanese banks were required by the U.S. regulatory authorities to provide the data according to the bilateral agreement, the MFJ initially prevented the banks from submitting the information to the U.S. regulatory authorities (*The American Banker* 12 March 1987). However, the MFJ worried that if Japanese banks did not comply with the U.S. and U.K. rules, it would be difficult for them to do business in U.S. and U.K. markets. The MFJ also believed that following the U.S. and U.K. rules would help Tokyo develop as a world financial centre. As a result, although there was limited commitment to strengthening the domestic capital regulations, the MFJ, in principle, determined to be in line with the United States and the United Kingdom.¹⁵⁹

Accordingly, MFJ's primary objective in negotiations with the United States and the United Kingdom was to reduce the costs of Japanese banks complying with an emerging common capital adequacy framework by connecting the negotiations to the Japanese capital adequacy guidelines of 1986 (see MFJ 1987: 41-42). A major issue in the negotiations was the inclusion of unrealised gains on securities holdings in the definition of regulatory capital. While the Japanese capital adequacy guidelines of 1986 allowed banks to count 70 percent of such gains, the U.S. and the U.K. regulations did not recognise them because of the volatility of the underlying equity markets (Ito and Sasaki 2002: 374; Tobin 1991: 236). The MFJ insisted on the inclusion of the unrealised gains in order to preserve the competitiveness of Japanese banks in international markets.¹⁶⁰ After a series of negotiation, the United States and the United Kingdom made a compromise with Japan to recognise 45 percent of the unrealised gains on securities holdings for capital adequacy purposes.¹⁶¹ By September 1987, the three

1987).

¹⁵⁹ Author's interview with Nishimura Yoshimasa.

¹⁶⁰ The MFJ commented: "[c]onsidering that a country's financial industry has become its important strategic industry in this post-industrialisation society, the *competitive conditions* for financial industries should not be neglected" (MFJ 1987: 42, emphasis added). The ministry also stated that Japan had to actively participate in the international cooperation to harmonise capital adequacy standards "in a way to properly reflect the situation of Japanese banks" (MFJ 1987: 42).

¹⁶¹ The figure of 45 percent was a decision to reflect the fact that 50 to 60 percent of such gains were taxed in Japan (Tamura 2003a: 113). In July 1987, the United States and the United Kingdom expressed that unrealised gains on securities holdings could function the same way as owned capital for Japanese banks (*Jiji Press* 15 June 1987). In the same month, Japan announced that that the country, in principle, agreed to go along with the bilateral agreement (see *Financial Times* 12 June 1987). After this sign from Japan for a common capital framework, the U.S. regulatory authorities began to approve the frozen applications of Japanese banks to expand business in U.S. markets (see *Japan Economic Newswire* 17 July 1987b; Murphy 1988).

countries also came to an agreement on other major issues, namely, the adoption of a two-tier structure of capital, and the use of a system of risk-weighted assets (Tobin 1991: 241-242). The trilateral agreement by Japan, the United States and the United Kingdom accelerated multilateral talks in Basel, which went at a slower pace than the trilateral discussions. As a consequence, the Basel Committee published a consultative paper containing proposals for a common capital adequacy framework in December 1987.

The compromise by the United States and the United Kingdom appeared to be necessary. After the announcement of the bilateral agreement, the regulatory authorities in the United States and the United Kingdom faced strong opposition from domestic banks and other institutions that its bilateral imposition would hurt the competitiveness of U.S. and U.K. banks.¹⁶² Moreover, the U.K. regulatory authority indicated to their U.S. counterpart that they might have to withdraw their commitment to the bilateral agreement as a result of the European objections to the agreement (Tobin 1991: 240).¹⁶³ Therefore, it was almost indispensable for the United States and the United Kingdom to conclude an agreement with Japan, and this situation gave Japan leverage in negotiations.¹⁶⁴ In addition, it should be emphasised that the ultimate reason why the United States and the United Kingdom sought an international capital standard was to strengthen their domestic capital regulations.¹⁶⁵ Accordingly, insofar as Japan agreed on a common capital adequacy framework, the United States and the United Kingdom were open to making a compromise.¹⁶⁶

For the Japanese banks and the MFJ the agreement was satisfactory, particularly due to the inclusion of the 45 percent of unrealised gains on securities holdings in the regulatory capital.¹⁶⁷ Even though Japanese banks initially demanded the recognition of

¹⁶² Peter Skorpil, Citicorp Japan division head, commented: "If the Japanese are not willing to live by the same rules, then we cannot afford to put Fed ratios into effect" (*The American Banker* 18 June 1987). Douglas A. Warner, Senior Vice President and General Manager of the London branch of Morgan Guaranty Trust, also said that the bilateral agreement would place U.K. and U.K. banks at a competitive disadvantage to European and Japan banks (*The American Banker* 20 January 1987). See also Kapstein (1989: 340, 1994: 114).

¹⁶³ See also Kapstein (1992: 282, 1994: 114-115).

¹⁶⁴ Author's interview with Nishimura Yoshimasa.

¹⁶⁵ As mentioned in the previous chapter, the U.S. bank regulatory authorities announced the adoption of a risk-weighted capital ratio approach in January 1986 in order to strengthen domestic bank regulations. However, U.S. banks protested this unilateral measure (Kapstein 1989: 339).

¹⁶⁶ Author's interview with Nishimura Yoshimasa. In fact, there was some opposition from the U.S. Congress when the U.S. regulatory authorities made an agreement with Japan and began to approve Japanese banks' applications for business in the U.S (Murphy 1988; Singer 2004: 552).

¹⁶⁷ Another important area in which Japan's preferences were reflected was the risk weight of

70 percent of such gains, this appeared to be a strategic demand for negotiation. During the 1980s, stock prices increased rapidly in Japan, and this led Japanese bank regulators and banks to hold a very positive view of Japan's economic growth. As a result, Japanese banks and bank regulators believed that the inclusion of 45 percent of such gains would be enough for the banks to achieve a CAR of 10 percent.¹⁶⁸ Indeed, after the establishment of the Basel Accord, the MFJ stated: "[w]e tried to reflect the peculiar situation of Japanese banks in the Accord. The Accord appears to fairly reflect our demand" (MFJ 1990: 46).¹⁶⁹ A senior Japanese banker also revealed that the perception in some quarters that Japanese banks were unhappy with the Committee's proposals of December 1987 was false (*The American Banker* 3 January 1988).¹⁷⁰ Moreover, some foreign observers even argued that the Basel Accord increased the international competitiveness of Japanese banks (Tamura 2003a: 113-114).¹⁷¹

After all, it was external pressure from the United States and the United Kingdom that forced Japan to accede to the Basel Accord. The Japanese, including the MFJ, had little intention of strengthening the domestic capital regulations, and, accordingly, what Robert D. Putnam (1988) referred to as "reverberation" effects did not occur within Japan, despite the launch of the bilateral agreement. Meanwhile, given the competitive threat from Japanese banks, the negative externalities that would have resulted for the U.S. and the U.K. banks as a consequence of noncompliance by Japanese banks with a common capital adequacy framework were enormous. In this situation, it was

claims on domestic public entities, excluding central government. The United States and the United Kingdom initially sought to allocate a risk weight of 20 percent to those assets, while the MFJ insisted on no risk weight for them or the same level as for claims on central government. In the end, reflecting Japan's demand, the Basel Committee allowed the regulatory authorities to choose either 0, 10, 20, or 50 percent at the national discretion (*Jiji Press* 13 July 1988, 15 July 1988).

¹⁶⁸ Author's interview with Nishimura Yoshimasa. The Japanese expected that the Tokyo stock market index would rise more than double in the mid-1990s (Tamura 2003a: 113-114).

¹⁶⁹ Finance Minister Miyaza Kiichi highly praised the Accord, saying "many proposals put forward by Japan have been accepted by the Cooke Committee" (*Japan Economic Newswire* 12 July 1988). Also, after the burst of the bubble economy in the early 1990s, Nishimura Yoshimasa, Director General of the Banking Bureau (1994-96), regretted that it was the ministry's misjudged strategy to find a point of a compromise with the West by incorporating unrealised gains into capital (see Sawabe 2002: 412 n. 43).

¹⁷⁰ In June 1988, Kusakawa Toro, Deputy President of Fuji Bank, a major Japanese bank, commented: "we feel the Japanese banks are for the present standards" (*The American Banker* 9 June 1988).

¹⁷¹ Standard & Poor's, a major credit rating company, expected that it would be easier for Japanese banks to comply with the Basel Accord than with the 1986 capital adequacy guidelines (*Financial Times* 9 June 1988). Meanwhile, Salomon Brothers, a major investment bank, anticipated that U.S. banks would find it difficult to meet the BIS standard (*The Economist* 12 December 1987).

imperative for the United States and the United Kingdom to force Japan to join a common capital adequacy framework. Accordingly, they put direct pressure on Japan by effectively closing their markets to Japanese banks. This situation altered the choice set for Japan, given the market power of the United States and the United Kingdom; maintaining the status quo was no longer an optimal choice for Japan. As a result, Japan decided to agree a common capital adequacy framework. Yet, the MFJ succeeded in concluding the agreement in a manner that did not involve significant compliance costs for Japanese banks.¹⁷² Thus, there was no significant domestic opposition to the Basel Accord in Japan. External pressure from foreign regulatory authorities and the low compliance costs explain why Japan agreed to accede to the Basel Accord.¹⁷³

Non-member incentives to follow

Did non-members of the Basel Committee also face pressure from the United States (and/or the United Kingdom) or from the Basel Committee to adopt and comply with the BIS standard? Unlike the case of Japan, there was no strong direct pressure from major countries on non-Committee countries, including Korea and Taiwan, to comply with the BIS standard. In fact, around 90 percent of international assets and liabilities of

¹⁷² Therefore, obviously, the Basel Accord did not eliminate competitive inequality between U.S. and U.K. banks and Japanese banks completely. Yet, as discussed above, after the establishment of the U.S.-U.K. bilateral agreement, the U.S. and U.K. bank regulatory authorities were in a situation where they had to conclude a multilateral agreement, especially with Japan. It is not clear how U.S. and U.K. banks and regulators viewed the effect of the Basel Accord on the real capital adequacy of Japanese banks during the late 1980s. However, the fact that Japanese banks withdrew their initial demand for the 70 percent of inclusion of unrealised gains on securities holdings was likely to help the U.S. and the U.K. bank regulatory authorities pacify domestic opposition to the Basel Accord in these countries. Moreover, although Japanese banks were actually satisfied with the Accord, they, on the surface, expressed that it would be difficult for them to achieve the required minimum CAR of 8 percent (see, for instance, *Jiji Press* 22 December 1987). In addition, it is noteworthy that the United States and the United Kingdom put pressure on Japan to liberalise its financial markets, while negotiating a common capital adequacy framework, and, as a result, the Japanese government allowed U.S. commercial banks to operate securities units in the Japanese market. The explicit linkage between this and the Basel Accord is not clear, but there was the possibility that the Japanese government allowed U.S. commercial banks to enter these markets in order to reduce pressure from the U.S. government on capital adequacy, or that the U.S. government used capital adequacy as a level to force greater access to the Japanese market for American banks (Oatley and Nabors 1998: 51). All these factors increased U.S. and U.K. bank regulatory authorities' incentives to make a compromise with their Japanese counterpart in concluding the negotiations for a common capital adequacy framework.

¹⁷³ Therefore, the establishment of the Basel Accord is not an instance of what Oatley and Nabors (1998) call "redistributive cooperation." Also, it differs from Kapstein's (1989, 1992, 1994) account, which is based on the theory of joint gains, given that there were few benefits to Japan in terms of the soundness of its banking system.

all banks in the world were held by banks from Committee countries, while banks from all the other countries in aggregate accounted for the remaining 10 percent (see Table 4.1). Therefore, Committee countries were not likely to have a strong incentive to make costly efforts to compel non-Committee countries to comply with the BIS standard. As a result, Korea and Taiwan did not experience *explicit* pressure from foreign countries—and from foreign banks—to adopt the BIS standard.¹⁷⁴

Table 4.1 International positions of banks by country, selected years, 1988-2002
(end of period; %)

| | 1988 | 1990 | 1992 | 1994 | 1996 | 1998 | 2000 | 2002 |
|--------------------|--------|--------|--------|--------|--------|--------|--------|--------|
| Assets | | | | | | | | |
| Basel Committee | 91.4 | 88.0 | 90.9 | 91.8 | 90.9 | 89.9 | 89.3 | 89.3 |
| (Japan) | (38.3) | (33.9) | (27.8) | (27.0) | (24.5) | (18.0) | (14.2) | (10.9) |
| The others | 8.6 | 12.0 | 9.1 | 8.2 | 9.1 | 10.1 | 10.7 | 10.7 |
| (Korea) | N/A | N/A | N/A | N/A | N/A | N/A | N/A | N/A |
| (Taiwan) | N/A | N/A | N/A | N/A | N/A | N/A | (0.7) | (0.7) |
| Total | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 |
| Liabilities | | | | | | | | |
| Basel Committee | 91.0 | 87.4 | 90.2 | 91.2 | 90.8 | 88.5 | 88.3 | 88.5 |
| (Japan) | (37.5) | (33.0) | (25.4) | (23.9) | (20.0) | (13.4) | (9.9) | (6.6) |
| The others | 9.0 | 12.6 | 9.8 | 8.8 | 9.2 | 11.5 | 11.7 | 11.5 |
| (Korea) | N/A | N/A | N/A | N/A | N/A | N/A | N/A | N/A |
| (Taiwan) | N/A | N/A | N/A | N/A | N/A | N/A | (0.7) | (0.7) |
| Total | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 |

Source: Bank for International Settlements, various issues of *BIS Quarterly Review*.

Note: The data covers cross-border positions in all currencies plus the local foreign currency positions of banks.

Yet, it is important to note that Committee countries did adopt certain low-cost measures to induce non-Committee members to comply the BIS standard. In fact, the Basel Accord expressly provided in its second paragraph as follows:

This document [the Basel Accord] is being circulated to supervisory authorities worldwide with a view to encouraging the adoption of this framework in countries outside the G10 in respect of banks conducting significant international business.

The Committee encouraged non-G10 countries to adopt the BIS standard by providing technical assistance (Simmons 2001: 605). Also, in international meetings of bank regulatory authorities, it was suggested that non-Committee countries adopt the BIS standard. For example, at the Fifth International Conference of Banking

¹⁷⁴ Author's interview with Wang Jiunn-Chih; author's confidential interview with a senior FSS official, Seoul, 28 January 2005.

Supervisors in 1988, which was held in two months following the establishment of the Accord, and in which about 180 bank regulators from 89 countries participated, non-Committee countries were urged to adopt capital adequacy standards similar to the BIS standard (*Japan Economic Newswire* 13 October 1988). In addition, even though the U.S. regulatory authorities did not close U.S. markets to foreign banks merely because their home countries did not implement the BIS standard,¹⁷⁵ the U.S. authorities certainly did take into account BIS standard implementation in approving the applications of foreign banks to expand their activities in U.S. markets (FSF 2001: 54).

Such activities targeted at BIS standard adoption by non-Committee countries did *not* lead the Korean regulatory authority to agree that the BIS standard was a desirable means of strengthening the soundness of the country's banking system. Yet, this encouragement for non-Committee countries to adopt the BIS standard gave the bank regulatory authorities in Korea and also in Taiwan a perception that the strengthening of capital adequacy standards was an international trend and that the BIS standard would become the main reference point for international banking standards.¹⁷⁶ Indeed, on its establishment, the BIS standard began to be cited as *the* international standard for capital adequacy regulation by the financial media and by leading international financial institutions. Accordingly, the Korean and Taiwanese regulatory authorities came to conclude that it would be necessary to adopt the "international standard" to avoid endangering business of Korean and Taiwanese banks in major countries (OBS 1991b).¹⁷⁷ This perception was not necessarily irrational given that there was a real chance that Basel Committee countries might tighten their rules on foreign bank affiliates at some point in the future.

The regulatory authorities' fear of foreign market closure for banks not complying

¹⁷⁵ In applying for the establishment of representative offices or branches, foreign banks from countries that did not implement the BIS standard were required to provide information regarding the capital standards applied by their home countries. The adoption of the BIS standard was not a necessary requirement to be qualified as "well-capitalised" under either the Banking Holding Company Act or the Gramm-Leach-Bliley Act to engage in non-banking activities. Foreign banks whose home country supervisors did not adopt the BIS standard might calculate their CARs under their home country standards. Insofar as CARs of foreign banks were deemed equivalent, not necessarily identical, to those required of U.S. banks, their operations in the U.S. market were not prohibited under U.S. regulations (Burand 1993; Hansen, et al. 2000).

¹⁷⁶ Author's interview with Wang Jiunn-Chih.

¹⁷⁷ Author's interview with Wang Jiunn-Chih; author's confidential interviews with a senior BoMA official, by email, 2 September 2004, and a former senior OBS official, Seoul, 3 February 2005.

with the BIS standard was likely to have been strengthened by their notice that one express objective of the Accord was to provide a “level playing field” among international banks and its establishment was largely attributable to the threat of market closure from the United States and the United Kingdom (see Kim 1991: 46-47). In addition, foreign branches of banks from non-BIS standard countries—including Korean and Taiwanese banks—were required to submit their BIS CARs to the foreign bank regulatory authorities (KEB 1991).¹⁷⁸ Even though no Korean or Taiwanese banks in Committee countries were subject to actual market closure due to their non-adoption of the BIS standard, the Korean and Taiwanese regulatory authorities perceived such a *possibility* to exist.¹⁷⁹

Moreover, the Basel Concordat, which was an agreement by the Basel Committee on principles for the supervision of banks’ foreign establishments, specified that a host country could forbid the operation of foreign establishments in its territory if the home country supervision of the parent institutions of such establishments was inadequate (BCBS 1983).¹⁸⁰ This principle was reemphasised in the 1992 revision of the Concordat (BCBS 1992). Besides, the 1992 revision stressed that “host country and home country authorities should at a minimum, give weight to the strength of banks’ capital” in reviewing their proposals for expansion (BCBS 1992). In this situation, the adoption of the BIS standard was expected to work as a bulwark against foreign criticism of their banking supervision. Wang Jiunn-Chih, former Director of BoMA, who was in charge of constructing the Taiwanese BIS standard, commented: “If anybody criticises us, we could defend ourselves by arguing that we are in compliance with the international

¹⁷⁸ Author’s interview with Wang Jiunn-Chih.

¹⁷⁹ In fact, Korean banks did establish overseas footholds in Committee countries, including the United States and United Kingdom, during the late 1980s and the early 1990s before Korea formally implemented the BIS standard from 1993 (see KFB, 1998). However, the approvals of the applications of the Korean banks to establish the overseas footholds appeared to reflect the foreign regulatory authorities’ evaluation that the capital levels of those banks were equivalent to the BIS CAR of 8 percent or were expected to meet the level. For instance, in the approval of the application by the Bank of Seoul to become a bank holding company by acquiring the Seoul Bank of California, a *de novo* bank, in August 1988, the U.S. regulatory authority pointed out that the bank’s ratios of tier 1 and tier 2 capital to risk assets exceed the 1990 transition standards in the Basel Accord (see *Banking Expansion Reporter* 3 October 1988).

¹⁸⁰ The U.S. Foreign Bank Supervision Enhancement Act of 1991 provided that a foreign bank seeking to establish or expand operations in the United States had to be subject to comprehensive supervision on a consolidated basis by its home country’s supervisory authority, including requiring the information on the applicant’s capital adequacy, although the capital adequacy of foreign banks was assessed on the basis of “capital equivalency,” which prescribed that capital ratios of foreign banks had to be equivalent, but not necessarily identical, to those required of U.S. banks (Burand 1993; Hansen, et al. 2000: 198-199).

standard [the BIS standard].”¹⁸¹

The Korean and the Taiwanese regulatory authorities therefore had a strong incentive to build such a bulwark by adopting the BIS standard, given that the majority of overseas establishments of Korean and Taiwanese banks were located in Committee countries, especially the United States. There were a total of 117 overseas establishments (48 branches, 54 representative offices, and 15 subsidiaries) of Korean banks at the end of September 1988; more than 60 percent of these establishments (73 establishments: 40 branches, 28 representative offices, and 5 subsidiaries) were located in the United States (18 branches, 9 representative offices, and 5 subsidiaries), Europe (10 branches and 12 representative offices), and Japan (12 branches and 7 representative offices) (see Son and Choi 1989: 71).¹⁸² Likewise, there were a total of 32 overseas branches and agencies or representative offices (18 branches and 14 agencies or representative offices) of Taiwanese banks in 1990 and, among them, 20 establishments (12 branches and 8 agencies or representative offices) were located in Committee countries, including 12 (8 branches and 4 agencies or representative offices) in the United States (see BoMA 1992: 8).

In addition, the Korean regulatory authority was encouraging Korean banks to establish branches to support the rapidly developing internationalisation of Korean firms (Lee, et al. 2004: 539-542).¹⁸³ In particular, as Korean banks were advancing into the markets of EC countries in preparation for EC integration, the implementation of the BIS standard by EC countries was expected to affect the business of Korean branches in EC countries (*Baengkeo* February 1991). The Taiwan government was also striving for the internationalisation of Taiwanese banks during the late 1980s and the 1990s in order to develop their international banking activities, to promote international trade, and to meet the demand of Taiwanese firm for investment and marketing abroad (BoMA 1992: 51, 1996b: 63-65). From 1988, the Taiwan government began to actively encourage and assist Taiwanese banks in establishing overseas establishments. As a result, while only three Taiwanese banks had eighteen overseas footholds in 1984, ten Taiwanese banks

¹⁸¹ Author’s interview with Wang Jiunn-Chih.

¹⁸² The five major Korean nationwide banks had a total of 31 overseas branches, 14 overseas representative offices and 8 overseas subsidiaries at the end of October 1988, and, among them, 27 branches, 5 representative offices and 4 subsidiaries were located in Committee countries (see Son and Choi 1989: 75).

¹⁸³ The government encouraged Korean firms to engage in direct foreign investments in order to advance into foreign markets as Korea’s current account balance turned into surplus from 1986. The total volume of foreign direct investment by Korean firms was only USD 650 million over the period of 1966 to 1986. However, the figure reached USD 150 million in 1988 and rose to USD 890 million by 1990 and to USD 3690 million by 1996 (EPB 1991; MoFE 1997).

had fifty four overseas establishments in 1992 (BoMA 1993a: 24, 1996b: 64).¹⁸⁴ In these circumstances, the Korean and Taiwanese regulatory authorities had to avoid endangering the overseas activities of Korean and Taiwanese banks.

Persistent fears of market closure, little pressure for comprehensive compliance

The risk of market closure in foreign countries gave the bank regulatory authorities in Japan, Korea, and Taiwan a strong incentive to adhere to the BIS standard. The incentives strengthened, especially for the Korean and the Taiwanese bank regulatory authorities, as the internationalisation of Korean and Taiwanese banks developed further throughout the 1990s. The number of Korean banks with overseas establishments almost doubled from 1990 to 1997, and the number of overseas establishments also almost doubled during this period. Although the internationalisation of Korean banks reduced after the 1997 financial crisis, the previous trend towards internationalisation continued from the early 2000s.¹⁸⁵ The number of Taiwanese banks with overseas footholds also more than doubled between 1991 and 2000, and the number of their overseas establishments rose more than three times during the period. Japanese banks also increased their overseas establishments until the mid-1990s, from 355 in 1990 to 437 in 1994, despite their weakening financial condition. Although the international presence of Japanese banks drastically declined from 1997/98, most major banks maintained their overseas establishments. Thus the Japanese regulatory authority also had an incentive to maintain the BIS standard (see Table 4.2).¹⁸⁶

¹⁸⁴ The total number of Taiwanese banks (domestic general banks) was thirty two in 1992.

¹⁸⁵ The size of the assets of U.S. branches or agencies of Korean banks grew from USD 6.4 billion to USD 16.6 billion between 1990 and 1996 (Haupt 1999: 611).

¹⁸⁶ Japan's defection from the BIS standard could also have had a negative impact on the effectiveness of Japan's delegation within the Committee (Whitehead 2005: 28).

Table 4.2 The international presence of Japanese, Korean, and Taiwanese banks, 1990-2003

(end of fiscal year; number)

| | Overseas establishments | | | Banks with overseas establishments | | |
|------|-------------------------|-------|--------|------------------------------------|-------|--------|
| | Japan | Korea | Taiwan | Japan | Korea | Taiwan |
| 1990 | 355 | 109 | N/A | 49 | 13 | 9 |
| 1991 | 377 | 119 | 54 | 54 | 14 | 10 |
| 1992 | 392 | 122 | 54 | 54 | 14 | 13 |
| 1993 | 422 | 131 | 70 | 53 | 15 | 14 |
| 1994 | 437 | 134 | 79 | 52 | 16 | 13 |
| 1995 | 428 | 149 | 91 | 53 | 18 | 14 |
| 1996 | 427 | 168 | 111 | 50 | 19 | 17 |
| 1997 | 404 | 190 | 131 | 43 | 21 | 20 |
| 1998 | 300 | 127 | 151 | 35 | 14 | 22 |
| 1999 | 243 | 102 | 156 | 26 | 11 | 23 |
| 2000 | 226 | 93 | 172 | 26 | 11 | 23 |
| 2001 | 165 | 79 | N/A | 21 | 9 | N/A |
| 2002 | 151 | 80 | N/A | 16 | 8 | N/A |
| 2003 | N/A | 84 | N/A | N/A | 8 | N/A |

Source: Japanese Bankers Association (formerly, FBAJ), various issues of *Zenkok Ginkou Zaimushyohyou Bunseki* (Analysis of Financial Statements of All Banks); Office of Bank Supervision (Financial Supervisory Services, from 1998), various issues of *Unhaeng Gyeongyeong Tonggye* (Bank Statistics); and Bureau of Monetary Affairs, various issues of *Caizhengbu Jinrongju Nianbao* (Annual Report Bureau of Monetary Affairs Ministry of Finance).

Note: 1. Overseas establishments include branches, representative offices and subsidiaries for Korean and Taiwanese banks, but only branches and representative offices for Japanese banks; 2. For Japanese banks, all banks are included; for Korean banks, all commercial banks are included; and for Taiwanese banks, all general banks are included.

In addition, the Basel Committee began to increase its efforts to strengthen the prudential regulatory framework in non-Committee countries from the mid-1990s. After the Mexican Peso crisis of 1995, the Group of Seven (G7) urged international financial organisations at the Lyon summit in 1996 to promote prudential regulatory measures in emerging markets in order to prevent the recurrence of a financial crisis in developing countries. As a result, the Basel Committee issued the Basel Core Principles in September 1997 (*Jiji Press* 29 April 1997; OBS 1997).¹⁸⁷ The Principles, which included the BIS standard, were intended to be implemented in “all countries and internationally,” and the Committee suggested that the IMF, the World Bank and other interested organisations use the Principles in assisting countries strengthen their regulatory framework and supervisory arrangements (BCBS 1997: 2).¹⁸⁸ Moreover, following the establishment of the Principles the U.K. regulatory authority took their

¹⁸⁷ The IMF also issued *Toward a Framework for Sound Banking* in March 1997 with a purpose similar to that of the Principles (OBS 1997).

¹⁸⁸ Indeed, as will be discussed later, when Korea entered into a stand-by arrangement with the IMF in the wake of the 1997 financial crisis, the country was required to improve its financial regulations to meet the Principles.

implementation into account as a primary factor in approving the applications of foreign banks to expand their activities in U.K. markets (FSF 2001: 51). The growing emphasis on the BIS standard was likely to strengthen the incentives of the bank regulatory authorities in Japan, Korea and Taiwan to adhere to the BIS standard.

Meanwhile, somewhat surprisingly, no foreign countries or international organisations compelled Japan, Korea or Taiwan to implement the BIS standard in earnest, except for Korea in the wake of the 1997 financial crisis, even though their compliance was cosmetic for most of the 1990s and the early 2000s.¹⁸⁹ Foreign countries and international organisations did resort to exerting symbolic informal pressure on these countries—especially on Japan—in order to improve the soundness of their banking sectors (Whitehead 2005: 34).¹⁹⁰ However, there was no further foreign pressure accompanied by actual sanctions. None of the countries faced substantial foreign pressure to cure their cosmetic compliance, insofar as they were formally in compliance.¹⁹¹ Also, even though some countries set a required minimum CAR higher than 8 percent, banks did not face serious problems in doing business in those countries insofar as they were in compliance with their home country regulations.¹⁹²

The absence of strong pressure for comprehensive compliance appeared to be attributable to the high costs that a country had to bear in exercising such extensive pressure. The Basel Committee overtly agreed that the regulatory authority in each Committee member country would implement the Basel Accord according to its individual legal structure and existing supervisory arrangements (BIS 1990: 10). In addition, so-called international standards were not established in most of the important accounting areas that could affect the effectiveness of compliance with the BIS standard. Under the circumstances, countries may have had to bear sizeable political costs in forcing others that were already formally in compliance with the BIS standard to

¹⁸⁹ This issue will be discussed in detail in the following chapters.

¹⁹⁰ In the summer of 1995, the IMF released a report heavily criticising Japanese authorities for their dealing with Japanese banks' NPL problems (Cargill, et al. 1997: 140). In 1998, G7 ministers and central bank governors requested that Japan's leaders use public funds to recapitalise Japanese banks. This call was reiterated by the IMF, World Bank, and the East Asia Economic Summit (Whitehead 2005: 35).

¹⁹¹ Author's interviews with Ito Takatoshi (Deputy Vice Minister for International Affairs, MFJ, 1999-2001), Tokyo, 1 March 2004, and Wang Jiunn-Chih; author's confidential interview with a senior FSS official, Seoul 18 February 2005. In fact, some foreign bank supervisory authorities, including the U.S. ones, carefully observed the CAR calculation process of Taiwanese banks with overseas branches in their jurisdictions. Nevertheless, foreign supervisory authorities did not demand the banks to improve their capital bases, either qualitatively or quantitatively (author's confidential interview with a banker of a major Taiwanese bank, Taipei, 27 August 2004).

¹⁹² Examples will be presented later in the country case studies.

strengthen their capital regulations. The extraordinary case was Korea under a stand-by arrangement with the IMF, because the arrangement lowered the costs for the IMF to exercise extensive compliance pressure.¹⁹³

This argument that high enforcement costs prevented countries from exerting strong pressure on others to strictly implement the BIS standard is supported by the fact that some countries employed less costly measures to improve the capital adequacy of foreign banks. The diplomatic and political costs to a country of insisting that foreign banks operating its jurisdiction meet capitalisation standards equivalent to those of the domestic banks were lower than the costs of pressuring the banks' home regulatory authorities to strictly implement and enforce the BIS standard, given that the former would be consistent with the "national treatment" norm. Indeed, the U.S. bank regulatory authorities required both U.S. and foreign banks to be "well-capitalised", which was defined as total CAR of a minimum of 10 percent and a tier 1 ratio of a minimum 6 percent, in order to engage in a broader range of nonbanking activities (Hansen, et al. 2000: 199-200, 225-226).¹⁹⁴ However, this regulation had little effect on the behaviour of Japanese, Korean, and Taiwanese banks, because first nonbanking activity was not a major international business for these banks, and secondly because the banks could engage in nonbanking business through their foreign subsidiaries incorporated in the United States (FBAJ 1989: 66, 1994: 63).¹⁹⁵

It is also worth noting that the incentive for major countries to put pressure on Japan, Korea, or Taiwan to strictly implement the BIS standard was not high during most of the 1990s and the early 2000s because of the limited competitive threat posed by banks from these countries. As Table 4.1 showed, banks from non-Basel Committee countries were never a serious competitive threat to major international banks, which were incorporated mostly in Basel Committee countries. Also, as mentioned earlier, the international presence of Japanese banks drastically declined after the mid-1990s.¹⁹⁶ Therefore, from the perspective of competitive equality and advantage, major countries did not have a strong incentive to force Japan, Korea, or Taiwan to implement the BIS standard in earnest.¹⁹⁷

¹⁹³ The magnitude of the negative externality generated by the Korean financial crisis also led the IMF to exercise such extensive compliance pressure on Korea.

¹⁹⁴ The CAR might be calculated according to the home country standards.

¹⁹⁵ Korean and Japanese banks' BIS CARs were lower than 10 percent and their tier 1 ratios were lower than 6 percent during most of the 1990s, while BIS CARs of a majority of Taiwanese banks were lower than 10 percent during the late 1990s and early 2000s.

¹⁹⁶ This issue will be discussed in detail in the following chapter.

¹⁹⁷ This analysis does not explain the absence of strong foreign pressure on Japan to

4.2 Compliance pressure from the market

The Basel Committee itself and most IR scholars who have studied the establishment of the Basel Accord have argued that there was strong pressure from the markets on bank regulatory authorities and/or banks to comply with the BIS standard.¹⁹⁸ However, they have presented few empirical findings to support their arguments, and have given limited information how such market pressures actually operated. Rather, they seem to take for granted the operation of the market compliance mechanism. This section provides a comprehensive analysis of market compliance pressures, by focusing on how credit ratings agencies (CRAs) incorporated banks' BIS CARs in rating them. This analytical short cut is appropriate given that credit ratings are an integral part of investors' risk management and, accordingly, banks' credit ratings affected their operations in markets, including their costs of borrowing.¹⁹⁹

Market response to the BIS standard

From the outset, the Basel Accord faced criticism for its failure to incorporate key insights from finance theory (see *Thomson's International Banking Regulator*, 25 October 1991).²⁰⁰ Its risk measurement framework did not generate a capital advantage for banks with well-diversified portfolios, even though finance theory indicates that they should be treated as less risky than banks with concentrated portfolios. Its system of five risk-weight categories was crude. The 8 percent minimum CAR was arbitrary, as it was not based on any particular insolvency probability standard. The different risk weights for OECD and non-OECD countries were also arbitrary and politically

comprehensively comply with the BIS standard during the early 1990s; this is explained by the analysis based on enforcement costs.

¹⁹⁸ See, for example, BIS (1990: 11, 1992: 20), Ho (2002), Kapstein (1994), Simmons (2001), and Singer (2004).

¹⁹⁹ According to a survey carried by the Japan Center for International Finance (JCIF) (2000), approximately 90 percent of 259 respondents (leading financial institutions and business corporations) regarded credit ratings as "one of the most important sources of information for determining ratings internally" or as "one of a variety of external sources of credit data (though not the most important) taken into account when assessing credit risk internally." See also FFH (2003) and JCIF (1999, 2001). According to an estimate, an 'AAA' bank could issue debt offering interest of between 0.1 and 0.6 percent less than an 'AA' bank due to the greater security it offered (*The Times* 5 March 1991a). Ito and Harada (2000: 18) also shows that news on rating downgrading had a negative effect on "Japan Premium", which was a premium imposed on Japanese banks' borrowing rate by U.S. and European banks in the Eurodollar and Euroyen market. See Sinclair (2005) for an IPE study of CRAs.

²⁰⁰ See also Karacadag (2000: 5).

motivated, and, as OECD membership expanded, the risk weights appeared to favour some countries that were less creditworthy than other non-OECD members.²⁰¹ The Accord did not cover various forms of risk such as operating risk. In addition, innovation by financial markets, in some cases with the intention of circumventing the Accord, eroded its effectiveness further (Greenspan 1998: 165; Karacadag and Taylor 2000: 5-7). As a result, the relationship between a banks' compliance with the BIS standard and its soundness was doubtful.²⁰²

Accordingly, the BIS standard was not accepted by CRAs as a reliable solvency regulation, and, in turn, the CRAs did not consider the BIS CAR a dependable solvency indicator.^{203,204} They did examine the BIS CARs of banks, and also frequently referred to them when they altered credit ratings for the banks; however, after they examined banks' BIS CARs they adjusted them to calculate the *economic* capital ratios by taking into account various factors.²⁰⁵ It was these capital ratios that influenced CRAs' rating decisions, and CRAs relied on their in-house models when they evaluated banks' economic capital ratios.²⁰⁶ In addition, for CRAs, the appropriate levels of capital that banks needed to hold differed according to their risk profiles.²⁰⁷

As a result, in allocating ratings for banks, CRAs were indifferent to whether they adopted the BIS standard or not. An analyst at Standard & Poor's (S&P's), a "big three"

²⁰¹ Moody's sovereign rating of Taiwan, which was not an OECD country, was Aa3 in March 1994, while the rating for Korea, which became a member of the OECD in 1996, was lower at A1 from April 1990 to October 1997.

²⁰² An IMF working paper (Sundararajan, et al. 2001) argues that credit risk and bank soundness are primarily influenced by macroeconomic and macroprudential factors and that the direct influence of compliance with Basel Core Principles on credit risk and soundness is insignificant. A World Bank working paper (Barth, et al. 2001b: 34) also suggests that there is no robust link between capital regulations and bank fragility.

²⁰³ The bank ratings methodologies of the three major CRAs—Moody's Investors Service, Standard & Poor's, and Fitch Ratings—are available from their websites: www.fitchratings.com, www.moody.com, and www2.standardandpoors.com.

²⁰⁴ There was the likelihood that less sophisticated market participants used the disclosed BIS CARs of banks in evaluating the banks' soundness due to a shortage of their resources for analysis.

²⁰⁵ There is no official definition of economic capital, but the underlying logic was that a bank's true economic capital should be permanent and readily available to compensate for massive losses before general creditors would be affected in any ways (Moody's 1999a: 37).

²⁰⁶ For instance, Fitch Ratings introduced "pure tier 1 capital", which was defined as tier 1 capital less tax effect, public funds and other preferred instruments, in assessing Japanese banks' actual capital soundness. Likewise, a number of institutions used their in-house assessments rather than external assessments such as IMF's Reports on Observance of Standards and Codes, when they took account of observance of international standards (FSF 2001: 7).

²⁰⁷ Alan Greenspan (1998: 166), former Chairman of the Board of Governors of the Federal Reserve System, argued that the inconsistencies between internally required economic capital and the regulatory capital standard might result in overrating the true capital condition of the bank, based on its disclosed regulatory CAR.

CRA, commented: “Standard & Poor’s did not [penalise banks that did not adopt the BIS standard]. Rather, Standard & Poor’s relies on its own assessment of the appropriate level of capital it considers a bank would require given the bank’s risk profile.”²⁰⁸ In other words, it was not a form of CAR but the actual soundness of a bank that affected its credit ratings. Thus, CRAs did not put pressure banks to adopt the BIS standard. In fact, even though the Daiwa Bank, a major Japanese bank, switched to the domestic capital standard and withdrew from the BIS standard in March 2000, its S&P’s long term credit rating did not change, remaining stable at BB+ from December 1998 to September 2001.

Given this, it not surprising that there was no positive association between BIS CAR and bank credit ratings. Moody’s Investors Service (hereafter Moody’s) (1999a: 29), another big three CRA, explicitly stated in its bank rating methodology: “[M]oody’s sees no automatic correlation between a bank’s level of regulatory capital and its credit ratings.” It also said: “Regulatory ratios give a very imprecise indication of capital strength. This is so even when regulatory capital ratios are based on risk-weighted models, such as the *Basle criteria*” (Moody’s 1999b: 32, emphasis added). In relative terms, capital was more important in emerging markets than in developed countries, given that volatility was greater in emerging markets (Moody’s 1999b: 31). Yet, Moody’s (1999b: 31) stressed: “Even in emerging markets, small adjustments in capital ratios are often of little consequence.” Fitch Ratings (2003b), the other big three CRA, also reported that the correlation between its long-term credit rating and tier 1 capital ratio was mildly negative, except for a group of major international banks. In other words, the market compliance mechanism, insofar as it was gauged by the CRA credit ratings, did not operate for the BIS standard.²⁰⁹

It should be noted that the neglect of the official BIS CARs by CRAs was not just a recent (after the late-1990s) phenomenon.²¹⁰ Even during the early 1990s, the link between the official BIS CAR and bank credit ratings was weak.²¹¹ For instance, the credit ratings of most major Japanese banks remained stable during this period despite a

²⁰⁸ Author’s confidential interview with a Standard & Poor’s analyst, by email, 11 August 2004.

²⁰⁹ Clear evidence that markets in general followed CRAs in assessing official BIS CARs is the change of the “Japan Premium” during the 1990s and early 2000s. The Japan Premium will be discussed in detail in the next chapter. Also, as will be discussed in Chapter 7, depositors did not shift money according to banks’ compliance with the BIS standard in Taiwan.

²¹⁰ As noted earlier, the Basel Committee began discussions to replace the 1988 Basel Accord with a new capital adequacy framework in 1999. See note 29.

²¹¹ In fact, in 1993, the Basel Committee issued a consultation paper, which discussed the amendment of the 1988 Basel Accord to incorporate market risks (Tamura 2003a: ch. 6).

fluctuation in their BIS CARs. For example, the S&P's Long-Term Issuer Credit Rating of Daiwa Bank was A+ in March 1990 (from August 1989) and remained the same in the subsequent rating assessment of April 1991, although its BIS CAR declined from 10.1 percent to 9.7 percent between March 1990 and March 1991.²¹² The rating of Fuji Bank was stable at A+ in the three consecutive rating assessments in March 1992, in November 1994, and in August 1995, while its BIS CAR rose from 8.0 percent to 8.7 percent from March 1992 to March 1995 (to 9.0 percent in September 1995). The rating of Dai-Ichi Kangyo Bank was A- in the two consecutive rating assessments in March 1991 and in June 1993, while its BIS CAR increased from 8.8 percent to 9.4 percent between March 1991 and March 1993; the rating stayed at A+ in the three consecutive rating assessments in October 1993, in November 1994, and in August 1995, although its BIS CAR fell from 9.4 percent to 8.7 percent from September 1993 to March 1995. The rating of Sumitomo Bank was stable at AA in the two consecutive rating assessments in March 1991 and in October 1992, although its BIS CAR fell from 8.9 percent to 8.4 percent between March 1991 and March 1992. Similarly, the rating of Sakura Bank remained stable at A+ in the two consecutive rating assessments in April 1990 and in April 1991, while its BIS CAR fell *below* 8 percent, to 7.9 percent, in March 1991 from 8.0 percent in March 1990. The rating of Sanwa Bank did not change at AA- in the three consecutive rating assessments in December 1992, in November 1994, and in August 1995, although its BIS CAR increased from 8.1 to 9.3 percent between March 1992 and September 1995. The rating of Tokai Bank was A- in the three consecutive rating assessments in March 1993, in November 1994, and in December 1997, although its BIS CAR fluctuated from 8.5 to 9.5 percent between March 1993 and September 1997. The rating of Mitsubishi Trust and Banking was A- in the two consecutive rating assessments in April 1993 and in November 1994, while its BIS CAR rose from 9.8 to 10.5 percent from March 1993 to September 1994. The rating of the Industrial Bank of Japan was stable at A+ in the four consecutive rating assessments in March 1994, in November 1994, in December 1995, and in February 1996, while its

²¹² Bank credit ratings are broadly categorised into two categories: traditional standard ratings and stand-alone ratings in terms of the factors that affect ratings. While traditional standard ratings take into account external credit risks and credit support elements, stand-alone ratings represent CRAs' opinion of the banks' intrinsic safety and soundness, excluding such elements. Fitch Ratings introduced stand-alone ratings, Individual Ratings, in 1980, and Moody's introduced its own, Bank Financial Strength Rating, in 1995. Meanwhile, S&P's has not issued stand-alone ratings. A S&P's Issuer Credit Rating is the CRA's "opinion of an obligor's overall financial capacity (its creditworthiness) to pay its financial obligations" (S&P's 2003: 44). This rating "focuses on the obligor's capacity and willingness to meet its financial commitment as they come due" (S&P's 2003: 44).

BIS CAR ranged from 8.6 to 9.1 percent between March 1994 and March 1996.^{213,214}

In fact, there was limited pressure from CRAs on banks to comply with the BIS standard comprehensively, although this pressure was not directly related to the BIS standard. Even though CRAs did not accept the specific rules in the Basel Accord, they agreed on its generic object that a bank had to maintain capital soundness. As a result, CRAs, to some extent, put pressure on banks to improve their actual levels of capital adequacy. They took into account the quality of the composition of the regulatory capital in assessing the creditworthiness of banks, usually discounting the value of tier 2 capital. Credit ratings of banks were also influenced by the CRAs' perception of the actual condition of assets, of which key indicators were the actual level of NPLs and the level of loan loss provisions. This is all driven by the CRAs' need to rate individual banks on an ordinal scale that is used globally.²¹⁵

However, the pressure from CRAs on banks to maintain actual capital soundness was not consistent. CRAs frequently did not downgrade ratings of banks, including stand-alone ratings, despite the deterioration of the banks' actual capital conditions.²¹⁶ This may have been partly attributable to the CRAs' shortage of resources for analysis of the actual capital conditions;²¹⁷ the resource limitation may have hindered the CRAs in analysing the banks' capital conditions properly.²¹⁸ Yet, sometimes CRAs did not downgrade a bank in spite of their acknowledgement of the bank's weakness. This happened mainly where there were clear signals from the government to support the bank.²¹⁹ As a result, CRAs could not put persistent significant pressure on banks to

²¹³ There were a total of twenty one Japanese "major banks" in March 1993: eleven "city banks" (Dai-Ichi Kangyo Bank, Sakura Bank, Fuji Bank, Mitsubishi Bank, Asahi Bank, Sanwa Bank, Sumitomo Bank, Daiwa Bank, Tokai Bank, Hokkaido Takushoku Bank, and Bank of Tokyo), three "long-term credit banks" (Industrial Bank of Japan, Long-Term Credit Bank of Japan, and Nippon Credit Bank), and seven "trust banks" (Mitsui Trust and Banking, Mitsubishi Trust and Banking, Yasuda Trust and Banking, Tokyo Trust and Banking, Chuo Trust and Banking, Nippon Trust and Banking, and Sumitomo Trust and Banking).

²¹⁴ Also, the rating of Korea First Bank remained stable at A- during the three consecutive rating assessments in June 1993, in December 1993, and in June 1995, while its BIS CAR fell from 10.2 to 8.7 percent between December 1993 and December 1995. Nor did the bank's S&P's Short-Term Issuer Credit Rating change during the three consecutive rating assessments in June 1993, in June 1995, and July 1996.

²¹⁵ I thank Andrew Walter for this point.

²¹⁶ For stand-alone ratings, see note 212.

²¹⁷ The problem of resources for analysis is common to most market participants (Karacadag and Taylor 2000: 16-17).

²¹⁸ Insufficient disclosure by banks may have aggravated the problem of analysis (see Moody's 1999b).

²¹⁹ This statement should not have been applied to bank stand-alone ratings. However, note that, as will be discussed in Chapter 6, stand-alone ratings of Korean banks, in general, did not change during the mid-1990s until the outbreak of the 1997 financial crisis, even though their

improve their actual capital soundness.²²⁰

The perception of market pressure

Surprisingly, despite the neglect of the BIS CAR by CRAs, it appeared that there was a common belief among banks and the bank regulatory authorities that the BIS CARs affected bank credit ratings. The following description by Moody's (1999a: 36) illustrates this tendency:

One common misconception is that the higher the level of capital the stronger the bank, regulatory solvency being considered as the defining factor for bank safety. ... More specifically on ratings, some market observers, investors, and banks themselves assume sometimes that there is a direct correlation between the level of bank capital and Moody's bank ratings. Sometimes banks inform Moody's analysts of a capital hike, and appear to expect a rating upgrade as a consequence. Conversely, bank managers contemplating a stock repurchase are apprehensive about a rating downgrade.

The perception that failure of banks to comply with the BIS standard would be penalised in the markets was prevalent.

Indeed, concern for banks' competitiveness in international financial markets was, along with concern over banks' business in major countries, the main reason why the Korean regulatory authority adopted the BIS standard. The regulatory authority anticipated that creditworthiness of Korean banks could be downgraded if the BIS standard was not adopted, and that Korean banks would have to pay higher costs when borrowing in international markets.²²¹ At that time, Korean banks always paid high interest rates when borrowing funds from international financial markets.²²² As will be discussed in detail in a later chapter, foreign loans traditionally played an important role

BIS CARs and actual capital conditions were declining.

²²⁰ Examples of how CRAs responded to actual capital conditions of banks will be presented in the country case studies.

²²¹ Author's confidential interview with a senior FSS official, Seoul, 31 January 2005. Even when the BIS standard was not yet implemented in Korea, the regulatory authority perceived that the Korea Exchange Bank, which was one of the major banks that provided foreign capital to the country, began to face problems in its international business due to its (estimated) low BIS CAR level of about 5 percent (NARK 1991: 24).

²²² Author's confidential interview with a former senior OBS official, Seoul 3 February 2005. For example, in 1991, Korean banks' borrowing interest rates were on average 36 b.p. higher than London Interbank Offered Rate (LIBOR: the interest rate at which banks offer to lend funds in the international interbank market, widely used as a reference rate for interest rate products) (see MFK and KDB 1993). See also Chae (1994).

in Korea's economic development until the 1997 financial crisis (see Table 4.3). Thus, the regulatory authority had to avoid a further downgrade in Korean banks' creditworthiness, and the adoption of the BIS standard was expected to help ensure this.²²³

Table 4.3 Shortage of domestic savings as a percentage of GNP by country, 1986-2003 (%)

| | saving rate - investment rate | | |
|------|-------------------------------|-------|--------|
| | Japan | Korea | Taiwan |
| 1986 | 4.1 | N/A | 21.3 |
| 1987 | 3.4 | N/A | 18.3 |
| 1988 | 2.6 | 9.2 | 11.4 |
| 1989 | 2.1 | 3.8 | 8.2 |
| 1990 | 1.4 | 0.1 | 6.8 |
| 1991 | 1.9 | -2.1 | 6.7 |
| 1992 | 2.9 | -0.4 | 4.0 |
| 1993 | 2.9 | 1.0 | 3.1 |
| 1994 | 2.7 | -0.6 | 2.7 |
| 1995 | 2.0 | -1.5 | 2.1 |
| 1996 | 1.4 | -3.6 | 3.9 |
| 1997 | 2.2 | -0.6 | 2.4 |
| 1998 | 2.9 | 12.4 | 1.3 |
| 1999 | 2.5 | 6.0 | 2.8 |
| 2000 | 2.5 | 2.6 | 2.9 |
| 2001 | 2.1 | 2.3 | 6.4 |
| 2002 | 2.8 | 2.1 | 8.9 |
| 2003 | 3.1 | 3.1 | 9.9 |

Source: The Bank of Korea, <http://ecos.BOK.or.kr>; Directorate-General of Budget, Accounting and Statistic, Executive Yuan, Republic of China, August 2005, *Guomin Jingji Dongxiang Tongji Jibao* (Quarterly National Economic Trends).

Note: Saving Rate = (GNP-consumption+net current transfers)/GNP or (1-consumption/GDP); investment Rate = Investment/GNP(GDP).

Given that Japan and Taiwan experienced surplus capital for investment, the market competitiveness of banks was not likely to be related to the macroeconomy in the countries as strongly as in Korea. Yet, the Japanese and Taiwanese regulatory authorities were not different from their Korean counterpart in believing that banks' noncompliance with the BIS standard would place them at a disadvantage in international financial markets. In addition, the Taiwan government had encouraged banks to operate international financial activities by providing various incentives for internationalisation since the early 1980s. This was likely to give the Taiwanese regulatory authority an incentive to adopt the BIS standard in order to protect or enhance Taiwanese banks'

²²³ Author's confidential interview with a senior FSS official, Seoul, 28 January 2005.

business in international financial markets.²²⁴ The Taiwanese regulatory authority's belief in market pressure for compliance remained firm through the 1990s and the early 2000s.²²⁵ For the Japanese regulatory authority, unlike their Korean and the Taiwanese counterparts, concern about the market pressure was not a major reason for the adoption of the BIS standard. In fact, Japan agreed with the United States and the United Kingdom to the principle of a common capital adequacy regulatory framework before any significant indication of the market pressure to comply with the BIS standard emerged. However, after the establishment of the BIS standard, the Japanese regulatory authority began to express the view that banks that failed to meet the BIS standard would suffer higher international funding costs (see *The American Banker* 20 April 1992).

The formation of the perception of market pressure

The conflicting findings that first the BIS standard was not accepted by market participants as a reliable solvency regulation and secondly that regulatory authorities and banks perceived that banks noncompliant with the BIS standard would be penalised in markets propose a puzzle: where did the perception of market pressure for compliance come from? It can be argued that the following three factors played an important role in generating the misperception: the necessity of capital adequacy regulations; the "legitimacy" of the BIS standard; and confusing signals from market participants themselves.

There is a consensus in the financial markets that a bank has to be governed by an appropriate capital regulatory framework in order to reduce the probability of its failure, even though there is no universal agreement on the best form of capital regulatory framework. Under information asymmetries and conditions for imperfect information, capital adequacy regulations can convey important information on the financial stability and soundness of a bank governed by the regulations (Simmons 2001: 602). In this

²²⁴ For instance, the Taiwan government enacted the Offshore Banking Act in 1983, and approved the establishment of offshore banking units of Taiwanese banks from 1984. The operation of offshore banking units was exempted from domestic regulations. In addition, offshore banking units were exempted from the reserve requirements on deposit and nonperforming loans, business income tax and stamp duties. As a result, the number of Taiwanese banks' offshore banking units had surged to twelve by 1990 (BoMA 1992: 12, 1996b: 64) and the total assets of offshore banking units grew five times between 1984 and 1990, from USD 4.3 billion to USD 21 billion.

²²⁵ Author's confidential interview with a senior BoMA official, by email, 2 September 2004.

situation, it may be plausible to expect that poorly-regulated banks would be penalised in markets because of their higher probability of failure. Conversely, banks governed by an appropriate capital regulatory framework may have a competitive advantage in the markets (Simmons 2001: 602). Yet, most market actors may agree that it would be infeasible to build an *optimal* capital regulatory framework, given such factors as real-time variations in bank risk-taking, uncertain volatilities associated with given risk positions, and so on (Freixas and Santomero 2003: 15-16). Therefore, in reality, market participants may accept a second-best regulatory framework as the appropriate one.

In these circumstances, the BIS had the “legitimacy” to be the second-best choice, in that it was established by the Basel Committee, which consisted of bank regulators from G10 countries, in other words, the most advanced economies in the world. This membership of the Committee may have granted the Committee the symbolic authority as the group of the world’s bank regulatory authorities and experts. In addition, even though there were debates on other forms of bank capital regulatory frameworks, none of the alternative ideas for capital regulation were actually accepted by a large number of major countries. In other words, there was no capital regulatory framework that could effectively compete with the BIS standard in the real world. As a result, the BIS standard was globally acknowledged from the outset as representing best practice in the area of bank capital regulation.²²⁶ Accordingly, it was not without foundation to expect or predict that banks not meeting the BIS standard would be penalised in markets.

In addition, major market participants themselves contributed to strengthening the perception of the market compliance pressure by sending confusing signals that may have led observers to make hasty conclusions on a positive link between banks’ compliance with the BIS standard and their market competitiveness. On 19 June 1987, the *Financial Times* reported that Moody’s was considering downgrading four major Japanese banks—Bank of Tokyo, Long Term Credit Bank of Japan, Mitsubishi Trust, and Sanwa Bank—due to their weak capital bases; Moody’s actually downgraded the credit ratings of the four banks the following month (*The Bond Buyer* 26 August 1987). Given that this downgrading occurred after the launch of the U.S.-U.K. bilateral agreement and that it was no secret at that time that Japanese banks’ CARs were relatively low,²²⁷ the downgrading by Moody’s may have generated the perception that

²²⁶ The media played an important role in creating this perception. For instance, *The Banker*, a leading banking magazine, began to use capital, as well as assets, as the criteria to list the world’s top banks after the establishment of the BIS standard.

²²⁷ The Chairman of the Bank of Tokyo severely criticised Moody’s, saying: “It’s no secret that Japanese capital ratios are lower than British or U.S. banks” (*Financial Times* 19 June 1987).

CRA would downgrade the credit ratings of banks that did not comply with “advanced” capital standards or “international standards.”

Moreover, as mentioned above, CRAs began to examine the BIS CARs of banks after the establishment of the Accord. CRAs’ bank rating manuals expressly put the BIS CAR on the list of factors taken into account in rating banks, although there were variations among CRAs in their bank rating methodologies. CRAs requested banks to submit their BIS CARs in rating them, even where their home country regulatory framework did not adopt the BIS standard.²²⁸ CRAs also frequently mentioned the BIS CARs of banks when credit ratings for banks changed. Even though such activities of CRAs were just part of their processes to determine the actual capital adequacy of banks, they were likely to foster the strengthening perception of the positive link between banks’ compliance with the BIS standard and their credit ratings.

In addition, although CRAs did not credit the BIS standard with reliable solvency regulations, they did stress that it was important for banks to comply with the BIS standard in order to avoid regulatory actions for noncompliance. Once the BIS standard was implemented, a bank’s compliance failure could be punished by the regulatory authority, and regulatory penalties could have negative consequences for a bank’s investors, general creditors and counterparties (Moody’s 1999a: 37, 1999b: 32; TRC 2004). This pressure from the CRAs on the banks to comply with the BIS standard was *not* the market compliance mechanism that the market-based theorists usually argue but a reflection of the need to comply with the relevant domestic regulatory framework. Nevertheless, it was clear that banks that were regulated by the BIS standard had to meet at least the required minimum CAR of 8 percent in order to avoid being penalised in markets.

Thus, there were reasonable grounds for the perception that noncompliance with the BIS standard would be penalised in markets. The perception of the market compliance pressure remained firm through the 1990s and the early 2000s.²²⁹ A pertinent issue that follows these findings may be whether the regulatory authorities perceived that market compliance pressure was for comprehensive compliance or for formal compliance. This study does not address this issue directly, but we can provide an indirect answer by considering whether the perceived market pressure induced the regulatory authorities to

²²⁸ Korean banks were requested by CRAs to submit their BIS CARs even before the implementation of the BIS standard in Korea (KEB 1991).

²²⁹ On the significance of perception in decision making under uncertainty, see Axelrod and Keohane (1986: 247-248).

implement the BIS standard in a way to increase comprehensive compliance. This issue will be discussed in detail in the country case studies.

4.3 Banks and external compliance pressures

The analysis of the compliance pressures from foreign countries and from the market has suggested that the bank regulatory authorities led the adoption of the BIS standard, especially in Korea and in Taiwan. What was the response of banks to the BIS standard? Did they also feel pressure from foreign regulatory authorities or from markets to comply with the BIS standard? If so, how did they respond to the compliance pressure?

Banks in Japan, Korea, and Taiwan appeared to share with their regulatory authorities the view that the adoption of the BIS standard was necessary given the threat of market closure. As discussed earlier, as Japanese banks faced the direct threat of market closure from the United States in 1987, they began to raise their CARs and forced the Japanese authorities to negotiate with their U.S. (and U.K.) counterparts. A small number of Taiwanese banks with low capital levels were initially opposed to the adoption of the BIS standard, but they retracted their opposition as Taiwanese banks seeking to expand their operations in foreign countries were required by the foreign regulatory authorities to submit details of their BIS CARs.²³⁰ Korean banks were also requested by foreign regulatory authorities to submit their BIS CARs, and, as a result, they agreed to the necessity of adopting the BIS standard in Korea.²³¹

Banks in Japan, Korea, and Taiwan also appeared to believe that their failure to meet the BIS standard would be punished in the markets.²³² The degree of banks' market sensitivity did not seem to make a difference in this belief of the banks. Table 4.4 presents the data of banks' reliance on foreign funds, which was used as an index to examine banks' sensitivity to market compliance pressures in this study. As the data shows only the size of funds raised from foreign sources, an exact comparison of the degree of the banks' reliance on foreign funds is difficult;²³³ nevertheless, it is shown

²³⁰ Author's interview with Wang Jiunn-Chih.

²³¹ Author's confidential interview with a senior banker of a major Korean bank, by phone, 26 August 2005.

²³² Author's interview with Wang Jiunn-Chih; author's confidential interviews with a banker of a major Taiwanese bank, Taipei, 27 August 2004 and a senior banker of a major Korean bank, by phone, 26 August 2005.

²³³ It would be better to divide the figures in Table 4.4 by the banks' total liabilities in order to gain an idea of their relative dependence on foreign funds. However, because of the problem of accessibility to the necessary data, this research provides only the size of banks' funds raised

that Japanese banks in aggregate raised more funds from foreign sources than did Korean or Taiwanese banks. However, no significant difference in the belief that failure to meet the BIS standard would be punished in the markets was found among banks in the three countries.²³⁴

Table 4.4 The size of banks' funds raised from foreign sources, by country, 1997-2005
(end of March of the year; USD billion)

| | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 |
|--------|-------|-------|-------|-------|-------|-------|-------|-------|-------|
| Japan | 704.6 | 648.9 | 562.6 | 477.5 | 545.1 | 482.3 | 515.2 | 548.2 | 649.9 |
| Korea | N/A | N/A | N/A | N/A | N/A | N/A | N/A | N/A | 54.2 |
| Taiwan | N/A | N/A | N/A | N/A | 25.8 | 26.0 | 33.8 | 51.4 | 57.5 |

Source: Bank for International Settlements, various issues of *BIS Quarterly Review*.

Note: the figures refer to the size of the liabilities recorded as external loans and deposits.

In fact, the banks' perception of market compliance pressure for the BIS standard was not based on evidence or concrete research.²³⁵ Instead, the perception appeared to stem from their general attitude of risk aversion. As banks generally do not want to draw negative attention to themselves, this provided an incentive for compliance with the BIS standard. Even if the banks did not have a clear understanding of the potential market costs of noncompliance with the BIS standard, it would be reasonable and rational for them to comply with the BIS standard in order to avoid being singled out in markets. Furthermore, particularly if the BIS standard was a weak regulation, not being able to meet it could still serve as a proxy of bank weakness.²³⁶ Indeed, most banks in the countries did not anticipate that they would be significantly penalised in international markets because of their CAR levels or the quality of their CARs, insofar as their CARs were higher than the required 8 percent minimum;²³⁷ nonetheless, most of them had a tendency to keep their CARs some points higher than 8 percent, if the costs were not high, simply because major foreign banks' CARs were around 10 percent.²³⁸

from foreign sources.

²³⁴ Author's interview with Wang Jiunn-Chih; author's confidential interviews with a banker of a major Taiwanese bank, Taipei, 27 August 2004 and a senior banker of a major Korean bank, by phone, 26 August 2005.

²³⁵ Authors' interview with Wang Jiunn-Chih; author's confidential interviews with a banker of a major Taiwanese banks, Taipei, 27 August 2004 and a senior banker of a major Korean bank, by phone, 26 August 2005.

²³⁶ I thank Andrew Walter for this point.

²³⁷ Author's confidential interviews with a banker of a major Taiwanese bank, Taipei, 27 August 2004 and a senior banker of a major Korean bank, by phone, 26 August 2005.

²³⁸ Author's confidential interviews with a banker of a major Taiwanese bank, Taipei, 27 August

Yet, despite their belief in the positive relationship between their compliance with the BIS standard and their market image, it should be emphasised that banks played only a passive role in adopting the BIS standard in Korea and in Taiwan. In other words, they were not opposed to the adoption, but they did not request it, either.²³⁹ Also, although a number of Japanese banks that were not required to employ the BIS standard voluntarily did so, most of them abandoned the BIS standard suddenly from 1998, when a Prompt Corrective Action (PCA) system was implemented in Japan.²⁴⁰ The attitude of banks towards the adoption of the BIS standard was affected by their CAR levels. Once the BIS standard became the domestic capital standard in a country, banks in the country faced the immediate risk of regulatory punishment from the domestic regulatory authorities for compliance failure. Therefore, banks with low CARs were reluctant to support the adoption of the BIS standard. Indeed, Korean banks were expected to have difficulties in meeting the required minimum of 8 percent before the implementation of the BIS standard in the country.²⁴¹ As mentioned above, the Taiwanese banks that were initially opposed to the adoption of the BIS standard were those with low CARs. Japanese banks also stopped adopting the BIS standard voluntarily as the likelihood that they would face regulatory actions for compliance failure drastically increased due to the implementation of a PCA system. The immediate risk of regulatory penalties from the domestic regulatory authorities made banks with lower CARs hesitant to adopt the BIS standard.

Once the BIS standard was implemented in Japan, Korea and Taiwan, banks in these countries faced pressure from the markets to comply with it. As discussed above, banks' failure to meet the BIS standard, which became their domestic regulations, could trigger regulatory actions against the banks, and, in turn, this could prompt market actors to lower their assessment of the banks. Furthermore, the adoption of the BIS standard provided a defined floor or benchmark, and falling below this would alert observers to the fact that a bank was having serious problems. This was because the regulatory 8 percent minimum was a ratio that every bank had to take care to meet, since not to do so

2004 and a senior banker of a major Korean bank, by phone, 26 August 2005.

²³⁹ Author's interview with Wang Jiunn-Chih; author's confidential interview with a senior BoMA official, by email, 2 September 2004, senior FSS officials, Seoul, 28 January 2005 and 16 February 2005, and a former senior OBS official, Seoul, 3 February 2005.

²⁴⁰ PCA refers to a regulation which establishes pre-determined levels of bank solvency deterioration which forces automatic enforcement actions (Barth, et al. 2001a: 19). This issue will be discussed in detail in the following chapter.

²⁴¹ Even though the BIS CARs of most Korean banks were over 8 percent in the late 1980s, the ratios were expected to fall below 8 unless they would adjust their behaviour (OBS 1991b; Song 1998: 14).

would involve regulatory penalties, which could include an order to liquidate; a bank's failure to conform to meet such an important requirement could signal to the market that it clearly had serious problems (Moody's 1999b: 32).²⁴² Even in the absence of regulatory penalties, as mentioned above, if the markets regarded the BIS standard as a weak regulation, it was reasonable for the markets to assume that only weak banks could not meet the standard.

In addition, it was requisite for banks in the countries that adopted the BIS standard to comply with the BIS standard if they intended to do business in foreign countries. This was also because the BIS standard became their home regulatory standard. Foreign banks had to comply, at least, with their home country regulations to expand their business in most countries, and capital adequacy was a salient factor for bank regulatory authorities to take into account in evaluating foreign banks' financial soundness.²⁴³ Therefore, international banks incorporated in Japan, Korea or Taiwan had to comply with the BIS standard, insofar as it remained as their home country regulatory standard.

After all, once banks were domestically subject to the BIS standard they faced external compliance pressures from the foreign regulatory authorities and from the markets. It is not easy to analyse the independent effects of these external compliance pressures and of domestic regulatory enforcement on compliance when all of them were in operation at the same time. Nevertheless, it should be stressed that the pre-eminent reason why banks complied with the BIS standard was to avoid regulatory actions from the domestic regulatory authorities, insofar as there were domestic regulatory penalties for compliance failure.²⁴⁴ This was because domestic regulatory actions could pose an immediate threat to banks' managerial freedom, which was the primary concern of most banks. Although the penalties from foreign countries or from markets could result in limiting the business activities of the banks, they were less likely to affect the banks' management. Indeed, as indicated above, banks were reluctant to support the adoption of the BIS standard despite the potential costs of non-adoption when their CARs were low and there was a significant possibility that the banks and their management would be threatened by domestic regulatory penalties.

²⁴² As mentioned above, even without regulatory penalties, if the BIS standard was weak, it was reasonable for markets to assume that only weak banks could not meet it.

²⁴³ For capital adequacy regulations of foreign banks in major countries, see FSF (2001: 43-57) and Gruson and Reisner (2000).

²⁴⁴ Author's confidential interviews with a senior banker of a major Korean bank, by phone, 26 August 2005, and bankers of major Taiwanese banks, Taipei, 27 August 2005 and 1 September 2005.

Conclusions

The externality-based compliance mechanism was an important element both in creating the BIS standard and in inducing countries to comply with it. The United States (and the United Kingdom) led the establishment of the common capital adequacy framework by the Basel Committee, seeking to reduce negative externalities that could have been generated by lenient regulations in other countries. In particular, the United States put direct pressure on Japan to join the common framework, as its failure to join could have generated serious negative externalities. Meanwhile, Basel Committee countries did not put substantial pressure explicitly on non-Committee countries to adopt the BIS standard, because the engagement of banks from these countries in international banking was limited. Nevertheless, the Committee did encourage the countries to implement the BIS standard, and this gave the regulatory authorities in Korea and in Taiwan the perception that non-adoption of the BIS standard would hurt the overseas business of Korean and Taiwanese banks. Concern for banks' business in major countries was persistent in Japan, Korea, and Taiwan throughout the 1990s and early 2000s, and thereby provided them with an incentive to adhere to the BIS standard during this period.

The operation of market compliance pressures was more complex than that of the externality-based compliance mechanism. Market participants did not accept the BIS standard as an appropriate capital regulation due to its flaws in terms of finance theory. As a result, the market compliance mechanism did not actually have a significant influence on the adoption of and the compliance with the BIS standard. Nevertheless, there was a common perception that banks that were not in compliance with the BIS standard would be penalised in the markets. This perception appeared to have been generated by various factors such as the consensus on the necessity that banks had to be regulated by an appropriate capital adequacy regulation, the fact that the BIS standard was established by the Basel Committee, and confusing signals from market participants themselves. This conception of market compliance pressure was another key factor that led Korea and Taiwan to adopt the BIS standard. Meanwhile, once banks were regulated by the BIS standard, they actually faced market pressure to comply with it formally, which was partly a reflection of the relevant domestic regulations.

While the analysis in this chapter has centred mainly around the adoption of the BIS standard in the case countries, the following three chapters will address the actual implementation of the BIS standard in these countries, providing a deeper analysis of

the effects of the three types of compliance pressures. The first country that will be addressed is Japan.

CHAPTER 5

Japan: Persistent Cosmetic Compliance

The environment for Japan's compliance with the BIS standard was radically changed during the 1990s. The economy collapsed, the financial condition of banks deteriorated, and, as a result, the cost for the banks to comply with the BIS standard soared. The changed circumstances substantially affected the implementation of the BIS standard. The first section addresses the change of the compliance costs. The second section examines Japan's compliance with the BIS standard and analyses the effect of compliance mechanisms on the compliance. The last two sections address the main factors that explain Japan's cosmetic compliance with the BIS standard.

5.1 The change of compliance costs

The costs for Japanese banks to comply with the BIS standard changed considerably with the turning point of the early 1990s. The MFJ constructed the Japanese BIS standard in a way to reduce the compliance costs of Japanese banks by fully exploiting the national discretionary elements in the Basel Accord. As a result, the banks were expected to have little difficulty complying with the BIS standard. However, Japan's economy collapsed in the early 1990s, and the economic downturn, which continued to the early 2000s, raised Japanese banks' compliance costs significantly.

The Japanese BIS standard of 1988

The Basel Accord was incorporated into Japan's banking regulations when the MFJ issued new administrative guidance in December 1988. There were two main concerns of the ministry in constructing the Japanese BIS standard. One was to formulate it comparably with BIS standards in other Basel Committee countries. Given that the main reason that the MFJ agreed to establish the BIS standard was to avoid foreign criticism and to protect Japanese banks' business in foreign markets, to maintain the comparability between the Japanese BIS standard and other Committee countries' BIS

standards was necessary for the MFJ.²⁴⁵ The other main concern of the MFJ was to reduce costs for banks to comply with the new capital regulation. As a result, the MFJ formulated the Japanese BIS standard by taking active advantage of the national discretionary elements in the Basel Accord in order to lower the compliance costs of Japanese banks, but within the boundary allowed in the Accord (see Table 5.1).²⁴⁶

Table 5.1 The Japanese BIS standard of 1988

A. Capital elements

Tier 1

- (a) Consolidated subsidiaries' minority interest
- (b) Capital on consolidated balance sheet
- (c) Paid-in capital
- (d) Capital reserves
- (e) Retained earnings
- (f) Non-cumulative perpetual preferred stock

Tier 2

- (a) 45 percent of unrealised gains on securities holdings
- (b) General loan loss reserves
- (c) Hybrid capital instruments
- (d) Subordinated term debt

B. Deduction from the capital base

From tier 1

The amount equivalent to goodwill and consolidation adjustment debt

From total capital

Holdings of capital instruments issued by other banks aimed at artificially raising capital ratios

C. Risk weights by category of on-balance-sheet asset

0%

- (a) Cash
- (b) Claims on OECD central government and central banks
- (c) Claims on non-OECD central government and central banks denominated in national currency
- (d) Claims collateralised by the lender's own account or securities issued by OECD central governments
- (e) Claims guaranteed by OECD central governments

10%

- (a) Claims on Japanese public sector entities
 - (b) Claims guaranteed by Japanese public sector entities
-

²⁴⁵ In fact, even though the MFJ initially planned to issue a new administrative guidance to carry the BIS standard in September 1988, the ministry did not issue it until it found that the BIS standards in other Committee countries were not significantly different from the Japanese BIS standard (*Japan Economic Newswire* 15 August 1988; *Jiji Press* 2 September 1988; MFJ 1990: 46; *The Associated Press* 16 December 1988).

²⁴⁶ Japanese banks requested the MFJ to include provisions for retirement allowances and reserves set up under specific laws in tier 2 capital, but the ministry did not allow it as they were earmarked provisions (*Euromarket Report* 25 April 1988).

20%

(a) Claims on multilateral development banks and claims collateralised by the securities issued by these institutions

(b) Claims on credit institutions incorporated in the OECD and claims guaranteed (or accepted or endorsed) by OECD-incorporated credit institutions

(c) Claims on bank incorporated outside the OECD with a residual maturity of up to one year and claims with a residual maturity of up to one year guaranteed by these banks

(d) Claims on OECD public sector entities (excluding central government), excluding Japanese ones, and claims guaranteed by such entities

(e) Cash items in the process of collection

50%

Loans fully secured by mortgage on residential property owned or rented out by the borrower

100%

All other claims and assets

Source: Ministry of Finance of Japan. 1989. *Dai 38-Kai Ginko-Kyaku Kinyu Nenpo* (The 38th Annual Report of Banking Bureau), pp. 48-51.

The most noteworthy characteristic of the Japanese BIS standard was that only “international banks” had the obligation to comply with the BIS standard. The Basel Accord was formally intended to be applied to “internationally active banks,” but it did not provide a clear definition of the term. Therefore, the Japanese regulation to apply the BIS standard to international banks only was not in breach of the Basel Accord. However, the Japanese definition of international bank was narrow, referring only to bank with overseas subsidiaries or branches. Therefore, although other banks engaged in transactions with foreign banks, they were not required to comply with the BIS standard under the Japanese regulations. “Domestic banks” were governed by the domestic capital adequacy standard, which was more lenient than the BIS standard. The domestic capital standard set the minimum CAR (capital to total assets ratio) at 4 percent and included all kinds of reserves in the regulatory capital. Thus, the application of two different sets of capital standards provided weakly-capitalised banks with room to retreat from the BIS standard. Domestic banks were allowed to adopt the BIS standard on condition that they would not reapply the domestic capital regulation once they employed the BIS standard. Yet, as will be discussed later, this condition was abandoned later to allow banks to switch to the domestic standard.²⁴⁷

The inclusion of 45 percent of unrealised gains on securities holdings in the regulatory capital initially substantially lowered Japanese banks’ costs of compliance

²⁴⁷ In addition, note that in establishing the 1996 amendment of the Basel Accord, the MFJ wanted to minimise its application scope, as the ministry worried that further regulations would put undue pressure on Japanese banks that were already struggling. The MFJ’s requirement was accepted by the Basel Committee. As a result, the MFJ expected that the additional burden of Japanese banks to comply with the 1996 amendment would be trivial (*Thomson’s International Banking Regulator* 23 March 1992; MFJ 1993: 37). See also note 46 for the Japanese implementation of the 1996 amendment.

with the BIS standard. Stock prices sharply rose during the 1980s, and, as a result, unrealised gains on securities holdings accounted for about half of the total capital bases of Japanese banks. This Japanese treatment was in sharp contrast to the corresponding German regulation. German banks also had a substantial amount of unrealised gains on securities holdings. However, the German regulatory authority held an austere view on them so that they allowed banks to count hidden reserves as part of tier 2 capital only up to 1.4 percent and then only after they had attained a tier 1 ratio of 4.4 percent (*The Banker* January 1993).

The Japanese BIS standard also reduced the volume of banks' risk-weighted assets. A risk weight of 10 percent was applied to claims on local public sector entities or government-related institutes and claims guaranteed by them, while the corresponding rule was 20 percent in the United Kingdom, and 20, 50 or 100 percent in the United States (Hall 1993b: 201). In fact, the MFJ initially planned to apply zero percent on the claims but decided on a 10-percent application due to opposition from the Basel Committee. Yet, the MFJ continued to insist on a zero-percent application on the claims in the Committee, and in the end, the Committee concluded in January 1994 that there was no significant problem in adopting it. One month after the committee's decision, the MFJ lowered the risk weight for the claims to zero percent (MFJ 1994: 25).²⁴⁸

In addition, the Japanese BIS standard was lax in the area of supervision. The MFJ investigated banks' compliance with the BIS standard on a basis of end-period assets twice a year, at the end of March (the end of the fiscal year) and the end of September (the end of the mid-fiscal year). The lax supervisory practice contrasted with U.S. supervision under which banks were expected to comply with the BIS rules at all times and were subject to random checks of such compliance. The Japanese supervisory practice made it possible for banks to window-dress their balance sheets; there was a rumour that non-Japanese banks guaranteed commercial credits for Japanese banks for a day, reducing risk-weights of Japanese credits from 100 percent to 20 percent (Scott and Iwahara 1994: 55).²⁴⁹

Moreover, the MFJ did not take punitive action against banks that failed to meet the capital adequacy regulations, either BIS or domestic, until a PCA system was introduced in 1998. In fact, the MFJ was not equipped with a statutory instrument to

²⁴⁸ The application of the low risk weight on the claims partly aimed to encourage the supply of funds for local public entities (MFJ 1994: 22).

²⁴⁹ In other words, the difference between the calendar year accounting period for non-Japanese banks and the end-March accounting period for Japanese banks was exploited (Scott and Iwahara 1994: 55).

enforce banks to meet the capital regulations until the introduction of the PAC system. Although the amendment of the Banking Law in 1992 established a new article empowering the MFJ to establish standards to assess banks' capital soundness related to their assets, there were, in contrast to Korea's and Taiwan's banking laws, no provisions to empower the regulatory authority to punish banks for noncompliance with the standards.²⁵⁰ However, the ministry was able to penalise banks effectively for noncompliance with administrative guidance if it was willing to do so, at least until the mid-1990s. Therefore, regulatory enforcement for banks to comply with the capital adequacy regulations was not a matter of ministerial capacity but of willingness. However, the MFJ had no willingness to enforce compliance, and merely suggested that noncompliant banks raised their CARs.²⁵¹

The Japanese implementation of the BIS standard effectively lowered costs of Japanese banks to comply with the BIS standard. The average BIS CARs of major banks surpassed the 8 percent minimum in September 1989, which was far earlier than the formal deadline of the end of March 1993.²⁵² In addition, the volume of total assets in all banks increased by about 20 percent during fiscal years 1988 to 1990. In the meantime, the Japanese BIS standard was formally in accordance with the Basel Accord, although the Japanese regulatory authority had no intention of complying with the BIS standard comprehensively.

Rising compliance costs

Japanese banks began to face difficulty in complying with the BIS standard from the early 1990s. In mid-1989, the BoJ started to raise interest rates to curb asset price inflation, paving the way for the asset price bubble to burst in 1991. Stock and land prices started falling rapidly and the economy remained stagnant throughout the 1990s and the early 2000s. The prolonged economic downturn placed unprecedented downward pressure on the CARs of Japanese banks.²⁵³

A drastic fall in stock prices rapidly eroded the volume of unrealised gains on securities holdings and consequently the capital bases of banks. After hitting a record

²⁵⁰ Nor were enforcement decrees or detailed enforcement regulations for the new article established.

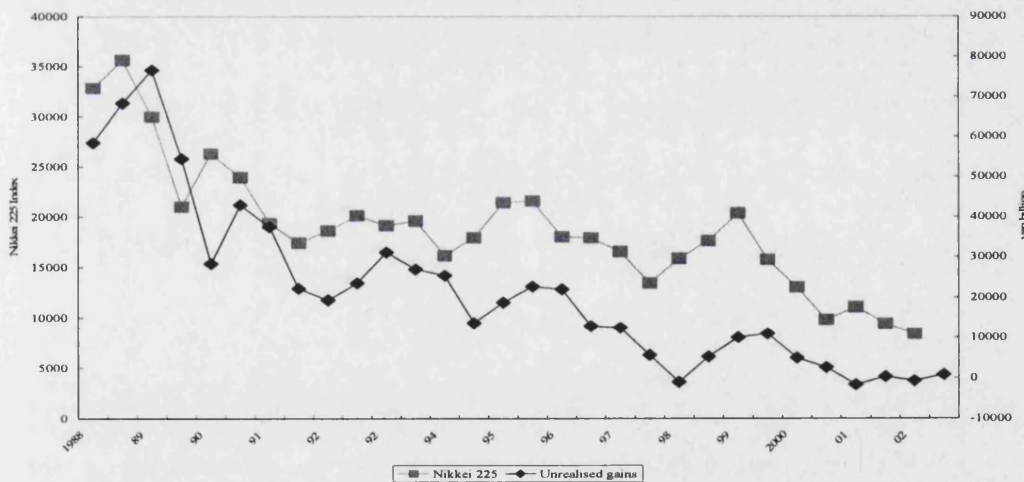
²⁵¹ Author's interview with Nishimura Yoshimasa.

²⁵² This finding challenges Oatley and Nabor's (1998) account of the establishment of the Basel Accord.

²⁵³ During 1991 to 2002, growth rates averaged only 1 percent per annum, compared to 4 percent during the 1980s.

high of 38,916 in December 1989, the Nikkei 225 Stock Average Index began to collapse. It lost more than half of its value by early 1992, and kept a downward trend, with cyclical fluctuations, falling to a 20-year low of 7,607 in April 2003. As a result, the volume of unrealised gains on securities holdings contracted substantially, losing about 80 percent in value by the end of March 1995 and eventually became negative for the first time during mid-1998, when the stock index fell below 15,000 (see Figure 5.1). According to an estimate by the government, a 1000-yen drop in the index pulled down CARs by 0.2 percentage points during the mid-1990s (EPA 1998: 265). The value of unrealised gains on securities holdings remained negative in the early 2000s. Although a change in accounting rules temporarily allowed banks not to record losses in their securities holdings between fiscal years 1998 and 2000, an introduction of mark-to-market accounting in fiscal year 2001 forced banks to deduct 60 percent of unrealised losses on securities holdings from their capital.²⁵⁴

Figure 5.1 The decline of unrealised gains on securities holdings in Japanese banks, FY 1988-2002
(fiscal year; JPY billion)



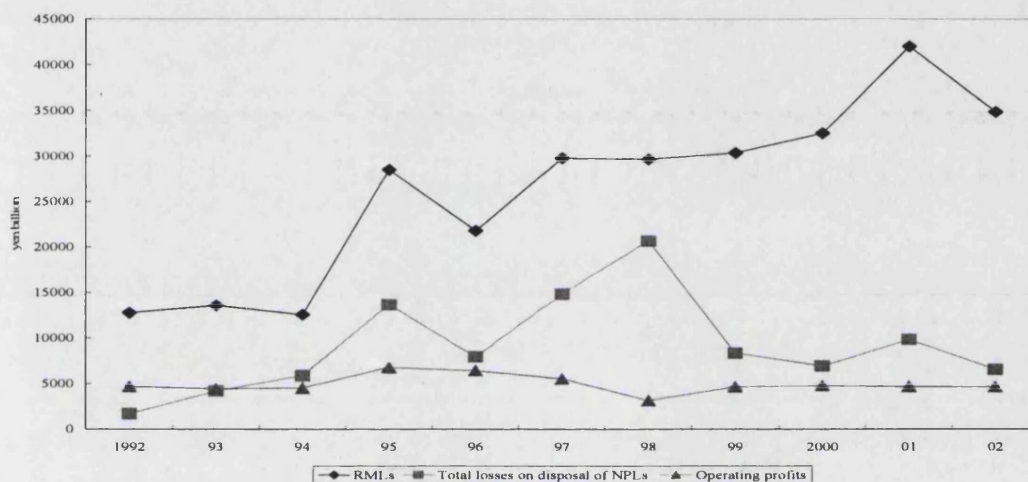
Source: Bank of Japan, *Japanese Banks' Financial Statements*; Nikkei NEED-MT Macro-Data.

In addition, a huge amount of loans held by banks turned into NPLs due to the prolonged economic weakness. The official volume of NPLs, Risk Management Loans (RMLs), in all banks reached JPY 42 trillion, which accounted for about 9 percent of the total loans at the end of March 2002. In consequence, banks suffered considerable losses in disposing of NPLs. They lost more than JPY 5 trillion in writing off NPLs,

²⁵⁴ The change of the accounting rules will be discussed in the next section.

either directly or indirectly, every year from fiscal year 1994. Since then total losses on disposal of NPLs surpassed operating profits (see Figure 5.2). The cumulative losses on the disposal of NPLs amounted to almost JPY 90 trillion (about 18 percent of 2003 GDP) by the end of March 2003. The loan losses encroached on the banks' profits and consequently their capital.²⁵⁵ Meanwhile, banks faced difficulties in raising new capital at affordable rates in the midst of a bearish market.

Figure 5.2 Disposal of NPLs in Japanese banks, FY 1992-2002
(end of fiscal year; JPY billion)



Source: Financial Services Agency, 2003, *Total Losses on Disposal of Non-Performing Loans of All Banks*; Bank of Japan, *Japanese Banks' Financial Statements*.

Note: 1. The definition of RMLs was strengthened in fiscal years 1995 and 1997; 2. For RMLs, the data are composed of only major banks from fiscal years 1992 to 1994.

Japanese banks were able to withstand the downward pressure on capital to some extent during the early 1990s owing to the huge size of unrealised gains and new CAR raising measures, such as subordinated debt, preferred stocks and asset securitisation, introduced by the MFJ.²⁵⁶ However, CARs of most major banks (city banks), on

²⁵⁵ A collapse in land prices impaired the value of collateral of extended loans, in many cases below the value of the loans they secured. According to an estimate by S&P's, a 10-percent decline in collateral values forced banks to make JPY 1 trillion in additional provisions (Rixtel 2002: 240).

²⁵⁶ The MFJ set out to devise the measures to help banks meet the BIS rules during the late 1980s (MFJ 1988: 37-38, 1989: 52), and accelerated the task as the banks' capital bases contracted due to the fall in unrealised gains (author's interview with Nishimura Yoshimasa). The issuance of subordinated convertible bonds with coerced conversion and foreign currency denominated perpetual subordinated bonds in overseas markets was allowed in July 1992. Banks were allowed to issue perpetual subordinated loans in September 1992. Euroyen denominated perpetual subordinated bonds and perpetual subordinated bonds with a condition of equity conversion were allowed in March 1993. A trust method was introduced for the

average, dropped below 9 percent in fiscal year 1994 for the first time since fiscal year 1992. The financial condition of Japanese banks was even more aggravated during the financial crisis of 1997 to 1998 and kept faltering throughout the remainder of the 1990s and the early 2000s. Consequently, the costs of Japanese banks to comply with the BIS standard have remained very high since the mid-1990s.²⁵⁷

5.2 Compliance of Japanese banks

Despite high and increasing compliance costs for banks, Japan formally remained a BIS standard country. However, Japan's compliance with the BIS standard was a clear example of cosmetic compliance; the Japanese regulatory authority implemented the BIS standard in a way to reduce compliance costs at the expense of the actual capital soundness of banks. External compliance pressures, along with domestic regulatory penalties from the late 1990s, induced Japanese banks' formal compliance with the BIS standard. Yet, there was no substantial pressure on Japanese banks to comply with the BIS standard comprehensively.

Cosmetic compliance record

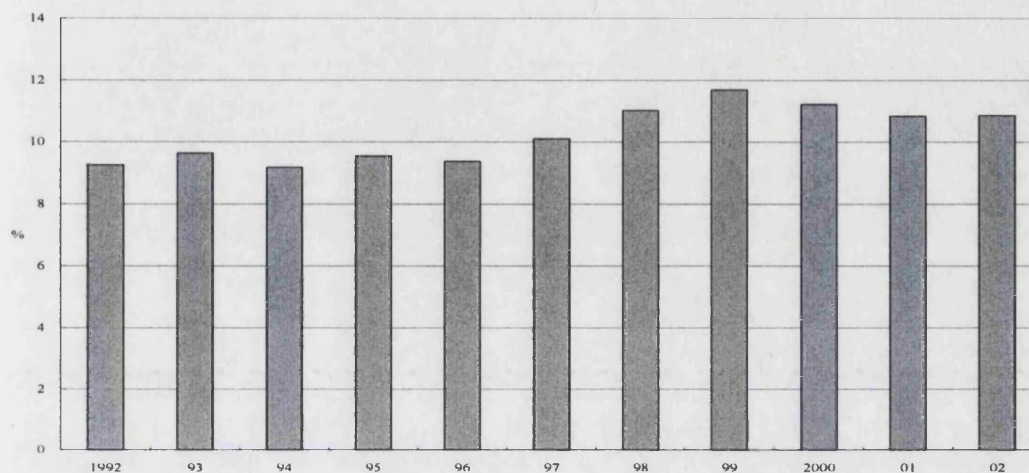
At a glance, Japanese banks seemed to show a fair record on compliance with the BIS standard. Most of banks that adopted the BIS standard complied with the required 8 percent minimum. There were only six compliance failures by the banks between fiscal years 1992 and 2002 on an annual basis: one in fiscal year 1992, two in fiscal year 1994, two in fiscal year 1996, and one in fiscal year 1998. In addition, CARs of BIS-standard banks on average surpassed 10 percent by the end of March 1998 and stayed over 10 percent afterwards (see Figure 5.3). This compliance record of Japanese banks made a remarkable contrast with their tattered compliance with the previous capital to deposits

securitisation of commercial loans in December 1992 and of loans to local public entities in April 1994 (MFJ 1994: 26-27). Some city banks issued preferred stocks in domestic markets and Euroyen denominated step down exchangeable subordinated bonds in overseas markets in March 1994. Others amended their corporate bylaws to ease issuing preferred stocks in June 1994.

²⁵⁷ The value of the yen to the dollar was another important macroeconomic variable that affected Japanese banks' CARs. Banks held a huge volume of dollar-denominated assets during the 1980s. The depreciation of the yen, therefore, expanded the value of the assets in yen terms and, in turn, encroached on banks' CARs. However, given that Japanese banks rapidly retreated from international markets from the early 1990s, the effect of fluctuations in the exchange rate on the banks' CARs appeared to be limited during the 1990s and the early 2000s.

ratio regulation.

Figure 5.3 The average CAR of Japanese BIS-standard banks, FY 1992-2002
(end of fiscal year; %)



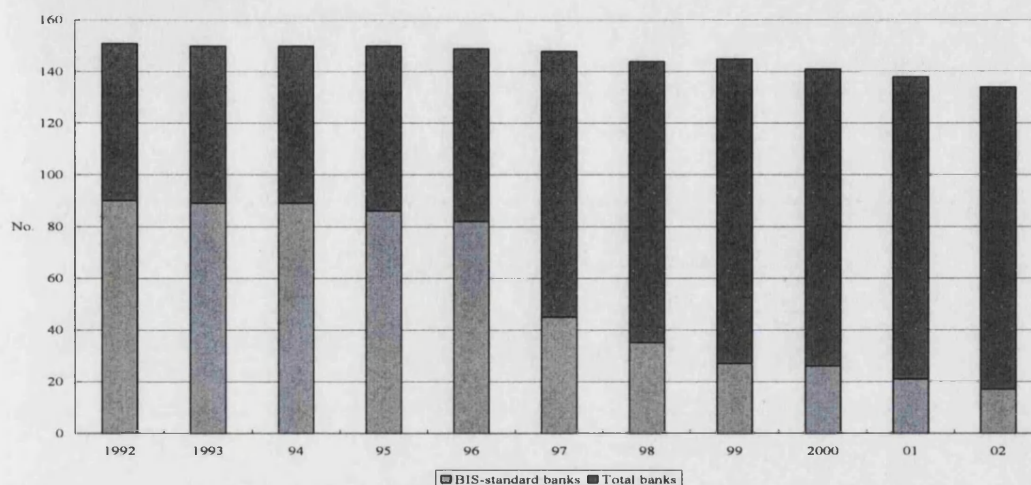
Source: Japanese Bankers Association, various issues of *Zenkoku Ginkou Zaimushyohyou Bunseki* (Analysis of Financial Statements of All Banks).

Note: Dai-Ichi Kangyo Bank and Fuji Trust & Banking are not included for the estimate for fiscal year 1999, and Mizuho Trust & Banking for fiscal years 2000 and 2001.

However, Japanese banks' compliance record should not be overvalued. The number of Japanese banks that employed the BIS standard sharply declined through the 1990s and early 2000s. Out of a total of 150 banks, 90 banks adopted the BIS standard at the end of March 1993, the deadline for the implementation of the BIS standard set by the Basel Accord. Yet, the MFJ removed the condition that prevented banks that had adopted the BIS standard from switching to the domestic capital standard one day before the introduction of a PCA system in April 1998.²⁵⁸ Half of the BIS-standard banks switched to the domestic capital standard on that day, and only about one tenth of Japanese banks—17 out of a total of 134 banks—adhered to the BIS standard by the end of March 2003 (see Figure 5.4). Although Japan officially remained as a BIS standard country, in practice, a very limited proportion of Japanese banks were regulated by the BIS standard from 1998.

²⁵⁸ Author's interview with Hirokawa Hitoshi (Deputy Director of Supervisory Bureau, FSA), Tokyo, 2 April 2004.

Figure 5.4 The number of Japanese BIS-standard banks, FY 1992-2002
(end of fiscal year; number)



Source: Japanese Bankers Association, various issues of *Zenkoku Ginkou Zaimushyohyou Bunseki* (Analysis of Financial Statements of All Banks).

In addition, BIS CARs of Japanese banks were inflated, failing to reflect the actual capital condition of the banks, due to lenient accounting rules. During the period before the PCA system was implemented, the inflation of the banks' BIS CARs resulted mainly from the MFJ's avoidance of recognising the actual scale of NPLs in banks.²⁵⁹ RMLs, the official definition of NPLs, included only loans to borrowers in legal bankruptcy and loans in arrears by six months or more during the first half of the 1990s. The definition of RML was extended in 1995 by including a part of restructured loans. However, the definition of restructured loans was limited and loans less than six months in arrears were not included in RMLs. The definition of RML was strengthened equivalent to the U.S. Securities and Exchange Commission in 1997, by including a broad range of restructured loans and loans in arrear by three months or more. Nevertheless, the reliability of the volume of disclosed NPLs remained doubtful. According to estimates by several U.S. and European investment banks, NPLs at major Japanese banks were almost double the disclosed figures (Rixtel 2002: 181). The limited disclosure of NPLs raised banks' CARs by reducing the volume of otherwise direct or indirect write-offs.

Once the PCA system was introduced, the regulatory forbearance in regard to the

²⁵⁹ The handling of NPLs through the Cooperative Credit Purchasing Company (CCPC) represented the MFJ's policy to deal with NPLs during the period. The CCPC commenced operations of the purchase and sale of NPLs with real estate as collateral in January 1993. The MFJ treated sales of NPLs by banks to the CCPC as if they were actual resolutions, excluding the figures of NPLs from their balance sheets. However, banks had to lend money to the CCPC for the purchase of NPLs without earning interest and any NPLs sold to the CCPC were not repaid until the underlying collateral was sold. Thus, in practice, the NPLs still remained in the banks' account (*Financial Regulation Report* 1 February 1994). By 1997, the CCPC had sold less than 5 percent of its portfolio (Kanaya and Woo 2000: 11).

capital adequacy regulation became more extensive. Along with the introduction of the PCA system, the new Financial Inspection Manual was introduced in April 1998.²⁶⁰ According to the Manual, although the quality of loans to “needs attention” borrowers was problematic, provisions for the loans were categorised as general provisions, inflating banks’ tier 2 capital.²⁶¹ Tier 1 capital was also artificially increased because NPLs in banks were highly under-provisioned due to a low level of provisioning requirements, especially for general provisions.²⁶² If all NPLs in banks had been provisioned, their tier 1 capital would have been exhausted by 2002.²⁶³

The regulatory authority also changed several accounting rules in order to help banks maintain their BIS CARs beyond the minimum 8 percent. As banks’ unrealised gains on securities holdings were expected to be negative, the regulatory authority permitted them not to record their unrealised losses from 1998. In the meantime, they were allowed to count 45 percent of unrealised gains on land holdings as tier 2 capital,

²⁶⁰ Along with the introduction of the Manual, banks were instructed to “self-assess” their assets and calculate the amount of write-offs and loan loss provisions based on their self-assessment results. The self-assessment scheme classified assets into four categories—category I (unclassified), II, III and IV—according to financial conditions of borrowers and collectibility of loans. Borrowers were classified as “normal”, “needs attention”, “in danger of bankruptcy”, “*de facto* bankrupt”, and “bankrupt” according to their ability to repay the obligation. “Needs attention” borrowers were subdivided into “special attention” borrowers and other “needs attention” borrowers (FSA 2003).

²⁶¹ A large proportion of borrowers were kept out of lower categories only because creditor banks continued to promise support to borrowers that were not expected to recover. For instance, the Japanese regulatory authority rated Aoki, a battered construction company, merely as a “need attention” borrower at the end of March 2001, although creditor banks waived its debts based on a 20-year restructuring plan that was too long to be convincing (*The Economist* 14 July 2001). Also, banks evaluated their borrowers based on their ability to repay interest, which meant virtually nothing in the extremely low interest environment. The IMF (2003b: 19) asserted that the provisions for “needs attention” borrowers should not be included in tier 2 capital, insisting that the accounting practice was not consistent with the Basel Accord, which prohibited the inclusion of special provision in the regulatory capital.

²⁶² Japanese banks were required to build provisions for loans to “need attention” borrowers that excluded “special attention” borrowers equal to prospective losses that they were expected to incur only over the following one-year period in view of their average loan loss ratio for the past three calculation periods. As a result, the ratio of loan loss provisions to RMLs for major Japanese banks ranged only from 30 to 60 percent from fiscal years 1992 to 2002, reaching about 40 percent at the end of the period. The ratio was significantly low compared with the ratio of loan loss provisions to NPLs in U.S. banks, which was above 160 percent from 1994 to 1999 (Fukao 2003a: 12-15). Although general provisions could be counted as tier 2 capital, their amount eligible for inclusion in tier 2 capital was limited to 1.25 percent of the risk-weighted assets and also tier 2 capital could not surpass the volume of tier 1 capital. Therefore, given that tier 2 capital in Japanese banks almost reached the level of tier 1 capital, most of an increase in general provisions could not be counted as capital, while reducing tier 1 capital by being recorded as loss.

²⁶³ According to a market estimate, under-provisioned NPLs in the four largest Japanese banks amounted to JPY 17,900 billion yen in 2002 (*The Banker* July 2002), while the amount of tier 1 capital in all major banks was JPY 3,713 billion at the end of the fiscal year.

even though this practice was in conflict with the accounting standard for unrealised losses on securities holdings.²⁶⁴ Banks were allowed to deduct the amount of time deposits from the lending balance of their clients in calculating CARs if the time deposits were to expire after the bank loans fell due (*Jiji Press* 26 March 1998). The risk weight applied to loans guaranteed by the Credit Guarantee Corporation was also reduced from 100 to 10 percent (*Japan Economic Newswire* 17 February 1998).²⁶⁵

Deferred tax accounting in calculating CAR was another problem. Japanese banks were allowed to include deferred tax assets (DTAs) in tier 1 capital from the end of March 1999.²⁶⁶ However, DTAs were not a reliable bank capital base because they lacked the availability to meet losses in the event of bank failure, which was one of the prime characteristics of bank capital (IMF 2003b: 18).²⁶⁷ Moreover, there was no limit to the amount of DTAs that Japanese banks could claim as capital as a percentage of tier 1 capital (*The Asahi Shimbun* 29 January 2003).²⁶⁸ As a result, for major banks, DTAs accounted for more than 20 percent of the tier 1 capital from fiscal year 1998, reaching 52 percent at the end of March 2003 (Cabinet Office 2003). However, DTAs depended on banks' ability to generate future income. Accordingly, the maximum amount of DTAs a bank could post should have been based on its future taxable profits. Yet, Japanese banks were too optimistic in calculating DTAs in spite of their weak future earning power.²⁶⁹

²⁶⁴ Although the accounting change was initially planned as a temporary measure to last until fiscal year 1998, the duration of the accounting change was extended so that banks could count unrealised gains on land holdings as capital as of April 2004.

²⁶⁵ In addition, restrictions on the sale of property-backed securities and the issuance of perpetual bonds were lifted (*Asia Pulse* 6 August 1997; *Financial Times* 1 April 1997), and banks were allowed to borrow subordinated loans from listed companies (*Japan Economic Newswire* 4 August 1997).

²⁶⁶ DTAs were credits against taxes on future taxable income. Japanese banks generated DTAs mainly with the following two factors. Firstly, the Japanese tax rules allowed loss carry forward for five years. As a result, when banks accumulated losses in taxable income, they could show DTAs up to combined tax rates (about 40 percent) of estimated taxable income in the following five years. Secondly, rules on the write-off of NPLs were stricter in tax accounting than in bank accounting. As a result, banks sometimes could not recognise losses in their statements for tax purposes, while they could in their financial statements. The over-paid tax on loan losses could be carried as DTAs (Fukao 2003b: 17).

²⁶⁷ DTAs had no liquidation value because the tax authority would not reimburse them in the case of a bankruptcy of the bank.

²⁶⁸ The U.S. regulatory authority limited DTAs to less than 10 percent of tier 1 capital or one year's profit (IMF 2003b: 18). In Korea, DTAs were completely prohibited from being included as capital.

²⁶⁹ For instance, Resona Bank, which received public funds in May 2003, had more than JPY 400 billion of DTAs, which was larger than its shareholders' equity of JPY 366 billion. However, the bank reported losses in the three period ending in March 2003. To realise the recorded DTAs in the coming five years, the bank had to earn JPY 200 billion every year and its after tax return

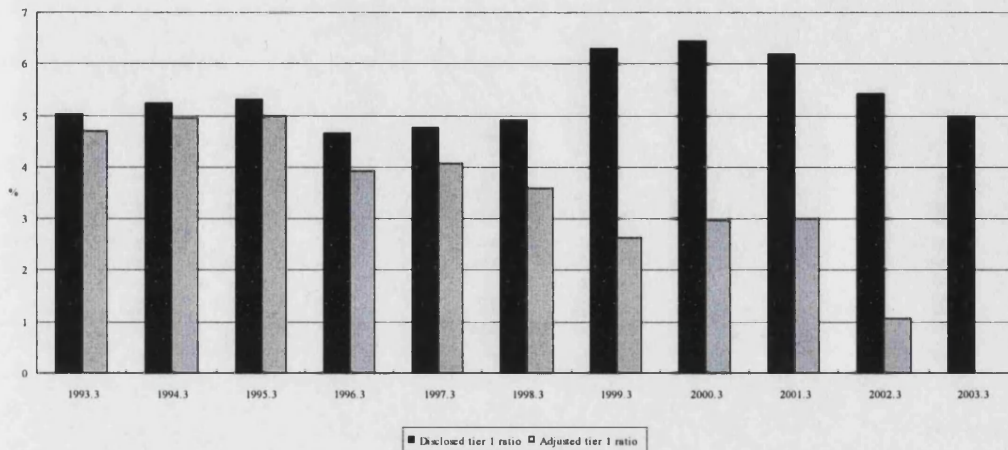
In addition, a large part of Japanese banks' capital was composed of public funds injected into the banks from 1998 in order to boost their weak capital bases. The government injected public funds of JPY 1.8 trillion into twenty-one banks, including eighteen major banks, in March 1998 and JPY 7.5 trillion into fifteen banks, including fourteen major banks, in March 1999 through the purchase of convertible preferred shares and subordinated bonds/loans (DICJ 2003a). The public funds raised the major banks' CARs by 2 to 3 percentage points to 10 percent or more. However, in a strict sense, the public funds were not a reliable capital base as they were debts that had to be paid back to the government.

Figure 5.4⁵ provides an estimate of the actual capital condition of major Japanese banks during fiscal years 1992 to 2002. Their disclosed tier 1 ratio was estimated by dividing their aggregate tier 1 capital by their aggregate risk-weighted assets, and then the disclosed tier 1 ratio was adjusted by deducting tax effects—including DTAs—and public funds from the tier 1 capital. The banks' disclosed tier 1 ratio was well beyond the required minimum of 4 percent during the period. However, the quality of tier 1 capital rapidly deteriorated due to an increase in the weaker capital elements from the late 1990s. The adjusted tier 1 ratio dropped to zero percent in March 2003. Given that this estimation did not take into account other problems related to the banks' regulatory capital—such as under-provisioning—their actual capital condition was likely to be far worse than the adjusted tier 1 ratio.²⁷⁰

on equity had to be as high as 32 percent. This was clearly an unrealistic scenario (Fukao 2003b: 17-18).

²⁷⁰ In fact, Hokkaido-Takushoku Bank, which went bankrupt in October 1997, had a CAR of 9.3 percent at the end of March 1997. Long Term Credit Bank, which failed in October 1998, maintained a CAR of 10.4 percent at the end of March 1998. The CAR of Nippon Credit Bank, which went bankrupt in December 1998, was 8.2 percent at the end of September 1998.

Figure 5.5 The adjusted tier 1 ratio of major Japanese banks, FY 1992-2002
(end of fiscal year; %)



Source: The author's own estimation based on the data obtained from Fitch Ratings.
Note: The number of major banks varies according to year.

Implications of the compliance record

The compliance record of Japanese banks, firstly, confirms that the operation of the external compliance pressures, both from foreign regulatory authorities and from markets, contributed to the formal compliance of Japanese banks with the BIS standard. As mentioned earlier, the MFJ did not penalise banks for noncompliance with the capital adequacy standards until the implementation of the PCA system in April 1998. In other words, there was no domestic compliance mechanism in operation during the pre-PCA period. Nevertheless, most banks that adopted the BIS standard complied with the required 8 percent minimum. Banks with lower BIS CARs made more effort than those with higher CARs in order to comply, by reducing loans or issuing more subordinated debts (Ito and Sasaki 2002). The compliance record of BIS-standard banks made a sharp contrast with the compliance record of domestic-standard banks, especially during the pre-PCA period; the number of compliance failures of domestic-standard banks reached about ten every year during the period (see Table 5.2). The comparison of compliance of the two groups of banks clearly shows that compliance of BIS-standard banks was induced by external compliance pressures, from foreign regulatory authorities and from markets.

Table 5.2 Compliance failures of Japanese banks, FY 1992-2002
(fiscal year; number)

| | 1992 | 1993 | 1994 | 1995 | 1996 | 1997 |
|-------------------------|------|------|------|------|------|------|
| BIS-standard banks | 1 | 0 | 2 | 0 | 2 | 0 |
| Domestic-standard banks | 12 | 11 | 9 | 10 | 12 | 1 |
| | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 |
| BIS-standard banks | 1 | 0 | 0 | 0 | 0 | N/A |
| Domestic-standard banks | 4 | 7 | 0 | 0 | 1 | N/A |

Source: Japanese Bankers Association, various issues of *Zenkoku Ginkou Zaimushyohyou Bunseki* (Analysis of Financial Statements of All Banks).

Secondly, the operation of external compliance pressures led some Japanese banks to voluntarily employ the BIS standard, particularly during the pre-PCA period. Approximately 40 percent of Japanese banks without overseas branches or representative offices chose to adopt the BIS standard during the period (see Table 5.3). Some of the banks employed the BIS standard because they had a plan to expand business in foreign markets. For example, in 1989, nine banks without overseas footholds announced adoption of the BIS standard in preparation for their future advance into international business (*Jiji Press* 15 February 1989). The remaining banks that had no overseas establishments, but opted to adopt the BIS standard, appeared to do so in order to improve their market images. External compliance pressures both from foreign countries and from markets induced banks' voluntary compliance with the BIS standard.

Table 5.3 Japanese banks' adoption of the BIS standard by bank category, FY 1992-2002
(end of fiscal year; number)

| | BIS-standard banks (A) | International banks (B) | Domestic banks | (A)-(B) |
|------|------------------------|-------------------------|----------------|---------|
| 1992 | 90 | 54 | 97 | 37 |
| 1993 | 89 | 53 | 97 | 37 |
| 1994 | 89 | 52 | 98 | 36 |
| 1995 | 86 | 53 | 97 | 36 |
| 1996 | 82 | 50 | 99 | 39 |
| 1997 | 45 | 43 | 105 | 10 |
| 1998 | 35 | 35 | 109 | 9 |
| 1999 | 27 | 26 | 119 | 1 |
| 2000 | 26 | 26 | 115 | 5 |
| 2001 | 21 | 21 | 117 | 5 |
| 2002 | 17 | 16 | 118 | 1 |

Source: Japanese Bankers Association, various issues of *Zenkoku Ginkou Zaimushyohyou Bunseki* (Analysis of Financial Statements of All Banks).

Note: International banks herein refer to banks with overseas branches or representative offices; domestic banks refer to banks with no overseas branches or representative offices.

Thirdly, as Table 5.2 showed, Japanese banks' compliance with the capital adequacy regulations, *both* BIS and domestic, improved after the implementation of the PCA system. This demonstrates that the threat of regulatory penalties from the domestic regulatory authority was the key incentive for banks' formal compliance with the capital adequacy regulations.²⁷¹ The PCA system required the regulatory authority to automatically take punitive actions against banks with CARs below certain thresholds, of which the highest was the required minimum CARs. Regulatory penalties ranged from the formulation and implementation of management improvement plans to the suspension of some or all business activities. Thus, banks had to meet the capital adequacy regulations to preserve their independent management after the introduction of the PCA system.

Fourthly, in the meantime, a sharp decline in the number of Japanese banks that adopted the BIS standard during the PCA period suggests that they attached a high priority to immediate costs that could be caused by their choice. The implementation of the PCA raised the risk that the banks could face regulatory penalties from the domestic regulatory authority, as their CARs were deteriorating. In the circumstances, banks were willing to bear potential market costs that could be generated by non-adoption of the BIS standard in order to avoid potential regulatory actions from the domestic regulatory authority, as the costs that would be caused by regulatory penalties were more concrete and tangible than the potential market costs.²⁷² Indeed, disclosed CARs of Japanese banks increased after the implementation of the PCA system, despite their worsening actual financial condition. In addition, it should be noted that banks with overseas establishments had to adhere to the BIS standard even during the PCA period, because otherwise their business in foreign countries could be limited. As of end-March 2003, of a total of sixteen banks with overseas branches, all except for Shinsei Bank, whose overseas branch was a paper company in the Cayman Islands, had adopted the BIS rules.²⁷³

Last, but not least, the cosmetic compliance record of Japan shows that the operation

²⁷¹ The PCA system was employed for domestic-standard banks from fiscal year 1999, one year later than for BIS-standard banks.

²⁷² In fact, a good number of banks that switched to domestic capital standard maintained their CARs at over 8 percent.

²⁷³ Precisely speaking, the Japanese capital adequacy regulations required a bank that had overseas branches or subsidiaries with a permanent executive director or permanent staff at its locations to comply with the BIS rules. Therefore, Shinsei Bank was not required to comply with the BIS standard under the Japanese regulations (author's interview with Hirokawa Hitoshi, by email, 12 April 2004).

of external compliance pressures failed to induce comprehensive compliance. In fact, whereas Japanese banks' capital condition worsened from the late 1990s, market participants paid less attention to the soundness of individual banks after the government's injection of public funds into the banks in the late 1990s: even though CRAs themselves argued that public funds were a weak form of capital, the injection of public funds had a positive effect on Japanese banks' credit ratings.²⁷⁴ Likewise, the "Japan Premium," which was a premium imposed on Japanese banks' borrowing rates by U.S. and European banks in the Eurodollar or Euroyen markets, virtually disappeared after the injection of public funds (Ito and Harada 2003).²⁷⁵ Foreign countries had difficulty forcing Japan to strengthen its capital adequacy regulations, since the Japanese accounting standards that artificially inflated the disclosed BIS CARs of the banks were not expressly addressed by the Basel Accord, and it was not clear whether Japan's application of such accounting standards was a noncompliance matter for the Basel Accord. Rules on asset classification and provisioning were not covered by the Accord; the accounting change to allow banks not to record their unrealised losses on securities holdings was not in violation of the Accord, because the Accord did not enforce the employment of mark-to-market accounting; the inclusion of unrealised gains on land holdings in tier 2 capital was explicitly allowed in the Accord; and the Japanese defended the inclusion of DTAs in the regulatory capital by arguing that the practice was reasonable since Japanese tax rules were extremely strict.²⁷⁶

There were more factors that may have reduced foreign countries' incentive to force Japan to implement the BIS standard more strictly. When the BIS standard was established in 1988, the immediate negative externality for foreign countries of Japan's noncompliance with the BIS standard was the competitive advantage of Japanese banks.²⁷⁷ Yet, even though the number of the overseas footholds of the banks increased

²⁷⁴ The long-term ratings of Moody's and S&P's for major Japanese banks, on average, rose or remained stable after the injection of a massive amount of public funds in April 1999 (see JCIF 2001: 9-10).

²⁷⁵ Meanwhile, credit ratings for Japanese banks were downgraded due to the introduction of a PCA framework, which helped compliance with the BIS standard. The CRAs understood the measure as a decrease in the safety net and in the availability of accounting flexibility or forbearance (*Japan Economic Newswire* 27 January 1997, 26 November 1997; *Jiji Press* 3 December 1997).

²⁷⁶ Japanese tax authorities limited the ability banks to deduct the amount of would-be uncollectible loans from their pretax income as an expense.

²⁷⁷ The S&P's Long-Term Issuer Credit Ratings for most major Japanese banks were A, which was assigned to an obligor with "STRONG capacity to meet its financial commitments," or AA, which was assigned to an obligor with "VERY STRONG capacity to meet its financial commitments," during the late 1980s and the early 1990s.

until the mid-1990s, their international market share began to decline from the early 1990s due to their weakening financial situations. As a result, while Japanese banks accounted for almost 40 percent of international assets of all banks in the world in 1988, their share declined to about 20 percent by 1997, and fell below 10 percent by 2003 (see Table 4.1). As the international presence of Japanese banks rapidly shrank, the competitive threat from them also decreased. In addition, Japan's comprehensive compliance could have had an adverse effect on foreign economies. As Japan's economy did not show a sign of recovery through the 1990s, foreign countries were putting heavy pressure on Japanese authorities to stimulate the economy (Cargill, et al. 2000: 163).²⁷⁸ Japan's economic recovery could have been adversely influenced by stricter capital adequacy regulation in the short term.²⁷⁹

5.3 Regulatory forbearance during the pre-PCA period

The analysis of compliance of Japanese banks with the BIS standard demonstrated that the Japanese regulatory authority actively fostered banks' cosmetic compliance by exercising regulatory forbearance. During the pre-PCA period, the effectiveness of compliance of the BIS standard was tarnished largely by the MFJ's hiding of the actual size of NPLs in banks. In fact, Japanese securities companies were under considerable pressure from the MFJ and banks not to make an issue of bank accounting problems (*The Nikkei Weekly* 14 October 1996). This section addresses factors that led the regulatory authority to implement the BIS standard cosmetically during the pre-PCA period.

The MFJ, the LDP, and banks

The Diet (the legislature) had to approve financial legislation, and the MFJ as a ministry could not have formal independence from the government.²⁸⁰ However, its regulatory

²⁷⁸ G7 countries, the IMF, and the World Bank requested Japan to recapitalise banks by using public funds (Whitehead 2005: 35).

²⁷⁹ In 1999, William McDonough, President of the Federal Reserve Bank of New York, defended Japan's application of the BIS standard to only international banks, despite the weakening capital adequacy of Japanese banks (*Jiji Press* 3 June 1999). Charles K. Whitehead (2005: 37) argues that foreign regulatory authorities showed considerable forbearance over Japan's cosmetic compliance with the BIS standard as they may have agreed that the country needed time to deal with it under severe banking difficulties.

²⁸⁰ Normally, regulatory authorities that form part of the executive branches tend to have a low

forbearance during the pre-PCA was not caused by problems of independence of regulatory authority. Rather, the MFJ enjoyed a high degree of independence from the ruling party, the Liberal Democratic Party (LDP), until the autumn of 1997, when the financial system turned into a crisis.²⁸¹ As long as the financial system was *perceived* as stable, politicians invested their political resources more in politically-sensitive niches of the economy such as agriculture, SMEs, and construction. As a result, while the Budget and Tax Bureaus of the MFJ were engaged in constant interaction with the LDP leadership, MFJ officials in Banking Bureau—and also those in Securities Bureau—had a good degree autonomy in policymaking from the LDP (Amyx 2003a: 4). In other words, the formal institutional arrangement that the bank regulatory authority was a government ministry did not lower its policy autonomy.

In addition, the Japanese financial laws were written broadly and vaguely, and this raised the policy autonomy of the MFJ by giving it discretion to fill the details. The MFJ heavily drew on ordinances, ministerial regulations, administrative notices or administrative guidance in regulating the banking sector, avoiding the enactment of legislation, which could have risked politicisation of banking regulation. In the meantime, it was the MFJ that controlled the national budget, although the ministry worked closely with politicians on budgetary issues (Amyx 2003a: 6-7). As a result, the regulatory authority did not face the problem of budgetary independence.

More importantly, there were few incentives for politicians to hinder the MFJ in implementing the BIS standard more strictly. The implementation of the BIS standard did not cause a substantial adverse effect on the economy during the pre-PCA period, contrary to the PCA period: Although there was a decline in bank lending during the early 1990s, it was because of a decrease in firms' demand for funds after the collapse of the bubble (Cabinet Office 2001).²⁸² Accordingly, there was no strong opposition from firms or from politicians against compliance with the BIS standard.

Rather, the reasonable demand from politicians would have been the call for stricter prudential regulation, if they had been concerned over the stability of the country's financial system. However, the LDP was not aware of the true financial condition of Japanese banks. The regulatory forbearance of the MFJ hindered politicians in understanding the actual financial status of banks. Banks also did not disclose

degree of independence (Quintyn and Taylor 2002: 20).

²⁸¹ Author's interview with Nishimura Yoshimasa.

²⁸² Indeed, the MFJ understood that a decrease in the demand for funds caused the decline of bank lending during the period (author's interview with Nishimura Yoshimasa).

information on their finances to politicians, whereas they shared the information with the MFJ. Information sharing with politicians could have caused the banks potentially significant costs, given that LDP leaders were strong supporters of the government-subsidised postal saving system, which competed with banks for deposits, and that there was a risk of information leaks, which are common in the political world (Amyx 2003a: 7).²⁸³

Meanwhile, there seemed to be a possibility that the cosy relations between the MFJ and banks may have induced the ministry to exercise regulatory forbearance in order to protect banks.²⁸⁴ A peculiar characteristic of Japanese financial regulation was the reliance on close informal ties linking the regulatory authority and financial institutions (Amyx 2003a: 5). The prominent examples of the informal ties were *mofutan*, *ama-agari*, and *amakudari*. *Mofutan*, literally “person in charge of Finance Ministry,” referred to positions in private financial institutions in charge of handling the MFJ, and they contacted MFJ officials face-to-face daily. *Ama-agari*, literally “ascent to heaven,” was the practice that employees from private institutions worked in the MFJ on temporary assignments. *Amakudari*, literally “descent from heaven,” referred to the re-employment of former high-ranked MFJ officials in private institutions (Amyx 2003a: 6).

The disclosure of the actual volume of NPLs could have lowered CARs of banks substantially. This would have damaged the banks’ overseas business and also tarnished their reputations in markets. In a worse scenario, public funds could have been injected into the banks in order to stabilise the banking sector, something that actually occurred in the late 1990s. The injection of public funds could have required the restructuring of banks, which could have limited managerial freedom, forced the resignation of senior bankers, and diluted the value of existing shares held by investors (see Amyx 2003a: 9). Therefore, banks had incentives to solicit lenient regulations from the MFJ through informal relations with the ministry.²⁸⁵

However, although the MFJ’s regulatory forbearance during the pre-PCA period corresponded on the surface with preferences of banks, it did not appear to result simply from banks’ lobbying. A series of scandals engulfing financial industries occurred

²⁸³ Banks pretended their problems were not serious by continuing to pay regular dividends until 1997, even though they reported losses from 1995 on (Patrick 2001: 23).

²⁸⁴ See Amyx (2001), Hanazaki and Horiuchi (1998), Horiuchi (2001), and Rixtel (2002).

²⁸⁵ A bank failure meant one less potential depository for retiring MFJ officials (Amyx 2003a: 6).

during the early 1990s,²⁸⁶ and these increased the MFJ's leverage over banks in banking regulation to a level they had not previously enjoyed so that the ministry could impose its will on banks (Amyx 2003a: 10). One notable example was the resolution of the *jusen* problem.²⁸⁷ In dealing with a massive amount of NPLs in *jusen* companies, which were non-bank subsidiaries of financial institutions specialising in housing loans, banks suggested the use of public funds to dissolve the companies in 1992. Yet, the MFJ rejected the proposal and introduced a 10-year restructuring plan in 1993, which required the *jusen* companies' "parent banks" (major shareholders) to reduce the interest rate on outstanding loans to zero and other bank creditors to lower the interest rate to 1.5 percent (Amyx 2003a: 10, 27 n. 36).²⁸⁸ Also, the MFJ prevented banks from realising unrealised gains on securities holdings or issuing new ordinary equities, as those measures could aggravate the weakening stock market. The alternative measures that the MFJ introduced for banks to raise capital were costly options for them.²⁸⁹ Therefore, regulatory capture by banks was not likely to be a main factor to explain the regulatory forbearance by the MFJ during the pre-PCA period.

Lack of the capacity to deal with compliance failures

Why did the MFJ exercise regulatory forbearance? The MFJ delayed recognising banks' actual financial conditions during the early 1990s partly due to its optimistic view of economic recovery. The MFJ believed that the economy would be revitalised quickly and the volume of NPLs would decrease.²⁹⁰ However, as the economy did not show signs of recovery until the mid-1990s, the MFJ adjusted its expectations of the future economy and recognised that the NPL problem in the banking system was serious (see

²⁸⁶ The scandals included fraudulent loan scams by five banks in 1991, loss compensation scandals by brokerages in 1991 to 1992, illegal stock trading by Daiwa Securities in 1992, and "racketeering" scandals surrounding banks and brokerage wherein these firms employed thugs for shareholder meetings (Amyx 2003a: 27 n. 36).

²⁸⁷ On the *jusen* problem, see Cargill, et al. (1997: 117-144).

²⁸⁸ Under the restructuring plan for *jusen* companies, other creditors (*nokyo*) were permitted to receive 4.5 percent in interest income from the companies (Amyx 2003a: 10). The final resolution of *jusen* companies were also against preferences of banks. This issue will be discussed again later in this chapter.

²⁸⁹ Fund-raising costs for subordinated debts were higher than those related with issuing ordinary equities, and asset securitisation could risk damaging banks' relationships with their traditional clients.

²⁹⁰ Author's interview with Nishimura Yoshimasa. In fact, a notable feature of Japanese postwar economic history was that economic downturns were quickly overcome. Therefore, it was not unreasonable that the Japanese perceived the economic downturn after the collapse of the bubble as little more than a short-term business cycle adjustment (Patrick 2001: 21-22).

MFJ 1994: 19-23, 1996: 13-19). Accordingly, the soundness of banks became a salient issue for the MFJ, and the ministry had to deal with ailing banks.

Yet, the MFJ lacked the capacity to deal with insolvent banks. The convoy system began to lose effectiveness during the mid-1990s. The financial deregulation from the late 1980s undermined the convoy system, by reducing the amount of regulatory rewards that the MFJ could give to cooperative banks (see Hoshi 2002: 164-169).²⁹¹ In addition, as the financial conditions of the overall banking sector deteriorated, there were few banks strong enough to merge with an ailing bank. Moreover, when rumours emerged that a bank was a candidate to rescue an ailing bank, the rescuing bank was penalised in markets with lower share prices. Therefore, banks cooperating in rescue mergers risked damaging their own creditworthiness in markets (Amyx 2003a: 12, 28 n. 41). As a result, the MFJ could no longer find any banks to rescue failing banks.

The MFJ endeavoured to compensate the decline in the traditional safety net by utilising funds in the Deposit Insurance Corporation of Japan (DICJ).²⁹² The MFJ assisted rescuing banks with subsidised funds. The first case of a DICJ-assisted rescue was the rescue of Toho Sogo Bank by Iyo Bank: the DICJ provided subsidised loans of JPY 8 billion over five years to Iyo Bank with the interest rate of 5 percent points below the government bond of the same maturity. Following the Toho Sogo Bank, the MFJ continued to provide DICJ assistance to banks to help failing banks (Hoshi 2002: 170-171). However, the DICJ assistance scheme had limits. Because deposit insurance was originally to protect small depositors, the Deposit Insurance Act restricted the amount of financial assistance to an acquiring bank to the cost that it would incur if it paid off all insured deposits (deposits less than JPY 10 million). Moreover, the size of deposit insurance funds amounted only to JPY 876 billion, which accounted for about 0.15 percent of total deposits in all banks and was smaller than the deposits of the average size of the smallest (second-tier regional) banks (USD 946 billion). Therefore, even the failure of a small bank could make the DICJ insolvent (Hoshi 2002: 171). As a result, the DICJ was not able to substitute for the convoy system, and the MFJ could no longer prevent bank failures (Murata and Hori 2004: 3).

Indeed, in August 1995, the MFJ allowed the Hyogo Bank, the thirty-eighth largest bank in Japan to fail. The bank failure was the first failure of a listed commercial bank

²⁹¹ On financial deregulation in Japan, see Hoshi and Kashyap (1999).

²⁹² The deposit insurance scheme was established in 1971, but under the operation of the convoy system it was never intended to provide a foundation for a system of guarantees (Cargill 2000: 44-45).

in postwar Japan (Peek and Rosengren 2001: 286). This event gave rise to investors' scepticism about Japan's financial safety net, and, as a result, a Japan Premium emerged that month for the first time since the first oil crisis in 1974 (Hanazaki and Horiuchi 1998: 7; Peek and Rosengren 2001). Also, depositors reacted to the bank failure by transferring their deposits from banks with low credit ratings to those with higher credit ratings or to the postal savings scheme (Kanaya and Woo 2000: 25). In short, while the traditional financial safety net began to unravel, a new one to replace it had not been established.

In the circumstances, the full disclosure of the actual size of NPLs in banks risked triggering financial instability in the economy. A rise in the volume of NPLs would have led CARs of a large number of banks to fall below 8 percent. The failure of the banks to meet the 8 percent minimum could have signalled the weakness of the already fragile banking system to markets, and, at worst, triggered an outbreak of financial panic in the absence of an adequate financial safety net. The regulatory authority had to avoid such a crisis of financial confidence.²⁹³ The MFJ's policy to spread recognising NPLs over a number of years was expected to preserve an aura of stability by allowing provisions to be paid from operating profits with no impact on capital, even if it would postpone the resolution of the NPL problem (*Financial Times* 30 January 1995).²⁹⁴ In other words, the MFJ had to help banks comply with the BIS standard formally, even though the compliance was cosmetic, in order to avoid a financial crisis in the absence of an adequate financial safety net.

It should be noted that this capacity problem in dealing with ailing banks had political causes, rather than it was purely resource-driven. Even though the convoy system stopped working properly, the government could resort to tax-payers' money in stabilising the financial system if necessary. Indeed, as mentioned earlier, the government injected a huge quantity of public funds into the banking sector during the late 1990s. The government budget deficit was smaller during the mid-1990s than during the late 1990s (see Table 5.4). Therefore, it is plausible to argue that the government could have developed the financial safety net during the mid-1990s, if it had wished to do so. However, the ruling party was not aware of the true financial condition of the banking sector until the overt financial crisis of 1997 as a consequence

²⁹³ The BoJ also understood by early 1993 that potential risks in the financial system could be larger than widely assumed, but it did not make its view public in order to avoid the possibility of triggering a financial crisis (Nakaso 2001: 18).

²⁹⁴ It was not until the introduction of the Comprehensive Plan for Financial Revitalisation in June 1998 that an explicit plan to address the NPL problem was established.

of the regulatory forbearance discussed above. The full disclosure of NPLs in banks could have exposed to the public eye the MFJ's failure to effectively regulate the banks, and this would have led to intervention from politicians in the MFJ's banking policies, constraining the MFJ's policy autonomy. Therefore, there was a strong political incentive for the MFJ to keep the NPL problem away from eye of politicians. This prevented the government from developing the official financial safety net.²⁹⁵ Furthermore, even if politicians had recognised the true status of the NPL problem, it would have been difficult for them to use and be accountable for a large volume of taxpayers' money to rescue ailing banks without political justification.²⁹⁶

Table 5.4 Central government overall deficit/surplus as a percentage of GDP by country, 1991-2004
(%)

| Fiscal Year | Korea | Japan | Taiwan |
|-------------|-------|-------|--------|
| 1991 | 0.2 | -0.5 | -3.6 |
| 1992 | 0.9 | -1.5 | -6.6 |
| 1993 | 1.7 | -2.4 | -4.9 |
| 1994 | 1.8 | -2.8 | -2.4 |
| 1995 | 2.1 | -3.4 | -2.8 |
| 1996 | 2.3 | -3.5 | -1.7 |
| 1997 | 2.4 | -2.8 | -2.4 |
| 1998 | 1.1 | -4.6 | 1.2 |
| 1999 | 1.1 | -5.5 | 0.5 |
| 2000 | 4.3 | -4.5 | -1.3 |
| 2001 | 2.6 | -5.1 | -2.5 |
| 2002 | N/A | -5.3 | -2.5 |
| 2003 | N/A | -5.7 | -3.2 |
| 2004 | N/A | -5.5 | -2.7 |

Source: Directorate-General of Budget, Accounting and Statistics, Executive Yuan, Republic of China, August 2005, *Guomin Jingji Dongxiang Tongji Jibao* (Quarterly National Economic Trends).

²⁹⁵ Indeed, as will be discussed in the following section, the overt financial crisis of 1997 led politicians to actively engage in banking policies, to establish the new financial regulatory authority, removing the authority of financial regulation from the MFJ, and to develop the official financial safety net.

²⁹⁶ Indeed, when the government used JPY 650 billion (about 7 percent of the volume of the public funds injected into banks in the late 1990s) in order to resolve the *jusen* problem in 1996, the government faced a strong public outrage. In this situation, using more public funds to resolve problems that could be regarded as caused by regulatory failure could have risked the political support for the ruling party. Indeed, as mentioned earlier, the suggestion from banks to use public funds to resolve the *jusen* problem was rejected by the MFJ in 1992, delaying the resolution of the problem for a long time. Meanwhile, as will be discussed in detail in the following section, the injection of public funds into the banking sector during the late 1990s was politically driven.

5.4 Regulatory forbearance during the PCA period

The main problem that hindered the regulatory authority in complying with the BIS standard comprehensively was rectified, or at least began to be cured after the late 1990s. The official financial safety net developed significantly so that there was a low likelihood that the failure of banks to comply with the capital standards would trigger a systemic financial crisis. A strong deposit insurance scheme was put in place in 1996 (see DICJ 2002, 2003b). A total of JPY 63 trillion (12 percent of GDP) was available for the government to stabilise the banking system, including the payment of deposit insurance claims, as at the end of 2003 (see DICJ 2003c).²⁹⁷ The political mechanism for crisis management was also simplified in 2000 so the government could authorise public capital injection even against the will of the bank in question (Callen and Muhleisen 2003: 33). However, new factors emerged to hinder the regulatory authority in implementing the BIS standard in earnest during the late 1990s and early 2000s: the diffusion of the compliance costs of the BIS standard from banks to SMEs, and the politicisation of banking regulation.

The diffusion of compliance costs

The environment surrounding compliance with the BIS standard was drastically changed by the introduction of the PCA system in April 1998.²⁹⁸ As discussed earlier, the PCA system forced banks to meet the regulatory minimum CARs at all costs to preserve their management. One method they took was to switch to the domestic capital adequacy standard, whose required minimum CAR was only 4 percent. However, most major banks had to comply with the BIS standard because they had overseas establishments. Yet, under the stagnant economy, their capital bases were sharply contracting while they were not able to raise new capital.

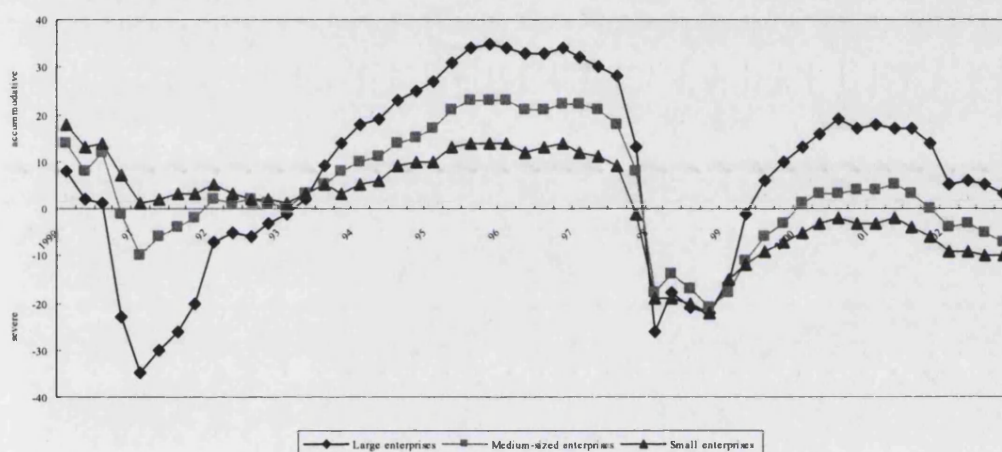
Banks responded to the changed circumstances by shrinking lending, whose risk

²⁹⁷ It is not very certain that the size of the funds would have been big enough to rescue all failing banks had compliance truly been complete. However, note that, as will be discussed in detail later, the Japanese bank regulatory authority established a plan to strengthen the Japanese BIS standard in the early 2000s. Without confidence in the financial safety net, it would have been difficult for the regulatory authority to build such a plan, given the weak financial condition of Japanese banks.

²⁹⁸ The MFJ introduced the plan to introduce a PCA framework in June 1996 as an attempt to increase transparency in the financial administration, responding to criticisms of its policy failures (*The Nikkei Weekly* 4 April 1996; *Financial Regulation Report* June 1996; *The Yomiuri Shimbun* 4 January 2000; MFJ 1997: 18-24).

weighting was 100 percent and which was the largest component of the total assets, in order to maintain their CARs above the regulatory minimums (Woo 1999: 8).²⁹⁹ The combined balance of loans extended by banks declined 1.6 percent year-on-year in March 1998, the steepest monthly decline recorded since July 1991, and the economy suffered from a credit crunch from 1997 to 1998 (Cabinet Office 2003; Kobayashi, et al. 2002; Woo 1999) (see Figure 5.6). A number of corporations went bankrupt and the implementation of the PCA system was widely criticized as one of the main causes (*Japan Economic Newswire* 22 December 1997).

Figure 5.6 The lending attitude of Japanese financial institutions, 1990-2002
(diffusion index; % points)



Source: Bank of Japan, 2003, Economic and Financial Data on CD-ROM.

Note: This figure shows the judgement of financial institutions' attitudes towards lending as perceived by the responding enterprises to the survey (*Tankan*) by the BoJ; the responding enterprises were asked to choose one alternative among three—"accommodative", "not too severe", "severe"—as the best descriptor of prevailing change, from three months earlier and three months hence, excluding seasonal factors.

In particular, SMEs were most harshly hit by the credit crunch. They relied heavily on bank borrowing whereas larger firms could rely on direct fund-raising from capital markets. While the ratio of bank debt to total debt for large firms declined from 85 to 66 percent between 1981 and 2001, the corresponding figure for SMEs stayed above 80 percent throughout the same period (Dell'Araccia 2003: 48).³⁰⁰ The number of bankrupt SMEs rose sharply from around 14,700 in 1996 to some 16,300 in 1997, and 19,000 in

²⁹⁹ Banks intensified their administrative cost-cutting efforts since the mid-1990s. As a result, they had a low cost structure, well below those of their U.S. and U.K. counterparts (Callen and Muhleisen 2003: 36).

³⁰⁰ Large firms are defined herein as corporations whose capital size is over JPY 1 billion, while SMEs are those with capital size of under JPY 100 million.

1998 (JSBRI 2003). Through the credit crunch mechanism, the costs of complying with the BIS standard were diffused from banks to the corporate sector, particularly to SMEs.

Although the kind of severe credit crunch that occurred during 1997 and 1998 did not recur, bank lending attitudes and the financial positions of SMEs remained tight during the early 2000s (Cabinet Office 2003). The injection of public funds into banks prevented further intensifying of the credit crunch by increasing the banks' capital base, but the amount of funds almost corresponded to the losses that banks incurred from disposing of NPLs (EPA 1999: 99). Meanwhile, except for a short rise in 1999, stock prices continued to decline, eroding the banks' capital bases. As a result, banks did not have enough capacity to increase their lending. Bankruptcies among SMEs increased again in 2000 after a brief decline in 1999, and more than 18,000 SMEs went bankrupt every year between 2000 and 2002 (JSBRI 2003).

The politicisation of banking regulation

In the meantime, banking regulation became rapidly politicised from 1997 on. Politicians began to engage actively in banking policies as the deteriorating health of the banking system turned into a financial crisis in the autumn of 1997, following the failures of high-profile financial institutions (Takumi 2002: 21).³⁰¹ Okihara Yasuoka, chairman of the LDP's influential financial stabilisation committee, expressed the determination of politicians to wrest control of financial regulation from bureaucrats: "The recent financial crisis has shown we can no longer rely on the Ministry of Finance to create policies because that is too slow—the politicians must do it too" (*Financial Times* 28 January 1998). Breaking the traditional policymaking process where bureaucrats drafted bills, politicians drafted and submitted bills to the Diet during the financial crisis of 1997 to 1998 (Motohisa 2002: 43-49; Takumi 2002: 19-25).³⁰²

The influence of politicians, especially the ruling LDP, on banking policymaking remained strong in the post-crisis period despite the creation of the new financial

³⁰¹ Hokkaido Takushoku Bank, which was the tenth largest commercial bank in the country, and Yamaichi Securities, which was the country's fourth largest brokerage, failed—along with another bank and another brokerage—in November 1997. Their collapse shocked the Diet and the public (Amyx 2003a: 19).

³⁰² The Government-Ruling Party Conference to Promote the Comprehensive Plan for Financial Revitalization was established in May 1998. It was a venue for government and the ruling party to discuss comprehensively effective measures to revive the financial system and promote concrete implementation of the "from the entrance to the exit" measures included in the Comprehensive Economic Package announced in April 1998.

regulatory authority, the Financial Supervisory Agency, which was reorganised into the Financial Services Agency (FSA) in July 2000.³⁰³ The Mori Cabinet (April 2000 to April 2001) depended wholly on the LDP for formulating the policy, increasing the concentration of power in the hands of the chair of the LDP Policy Research Council (Takumi 2002: 36).³⁰⁴ In addition, LDP's powerful "financial policy tribe" (*okura zoku*), which had previously focused on budgetary and tax issues (Amyx 2003a: 5), exercised much power in banking sector policy behind the scenes (Walter forthcoming).

The institutional framework of the new regulatory authority also made it vulnerable to political pressure. Even though the FSA inherited a large number of staff from the MFJ, the traditional strong informal network between bank regulators and banks virtually disappeared after the establishment of the new regulatory authority (Amyx 2003b: 50-52; IMF 2003b: 76). However, although the FSA was an external agency of the Cabinet Office, the Minister for Financial Services, who was a member of the Cabinet and was answerable to the Diet, had effective control over the operation of the FSA. The management control of the Minister over the FSA created scope for political interference.^{305,306} In addition, unlike most supervisory agencies, there was no board with outside members or other form of collegiate decision making body to whom the Commissioner, the chief executive of the FSA, could be accountable. The FSA also had no budgetary independence, being funded from the central government budget (IMF 2003b: 30, 38, 76). Moreover, the FSA had resource constraints, which slowed inspections of banks (Walter forthcoming).³⁰⁷

³⁰³ In June 1998, the government established the Financial Supervisory Agency as an administrative organ responsible for the inspection and supervision of private sector financial institutions, with the objective of removing control of financial sector regulation from the MFJ. The Financial Supervisory Agency worked in conjunction with Financial Policy Bureau of the MFJ until July 2000, when the two bodies were combined and reorganised to become the Financial Services Agency. The FSA became responsible for planning of the financial system for which the MFJ had been responsible. The Financial Supervisory Agency and the FSA was under the auspices of the Financial Reconstruction Commission (FRC), which operated from December 1998 to January 2001 as a temporary body to deal with failed financial institutions. The FSA assumed all the duties of the FRC in January 2001, when it was abolished (FSA 2005; IMF 2003b).

³⁰⁴ See Takumi (2002: 37) for the policymaking mechanism of the LDP.

³⁰⁵ Financial Services Minister Yanagisawa Hakuo (2001-2) was sacked by the LDP because he was opposed to the party's proposal to inject public funds into banks.

³⁰⁶ All significant reports on individual banks were referred to the Minister (IMF 2003b: 76). Minister Yanagisawa strongly defended that Japanese banks were healthy in terms of capital adequacy (*Japan Economic Newswire* 12 April 2002). It was said that although the Inspection Bureau of the FSA was willing to publish more accurate figures on NPLs, it was overruled by the Supervisory Bureau, which was under the control of the Minister (Walter forthcoming).

³⁰⁷ Supervision and inspection of regional banks were in practice delegated by the FSA to local branches of the MFJ (Walter forthcoming).

As the financial positions of SMEs deteriorated and their bankruptcies increased, the LDP began to make desperate efforts to protect them. SMEs were the major economic actors in the economy, accounting for more than 50 percent of value added generated by all corporations (JSBRI 2003: 50). They were also politically important actors, because the large number of SMEs made them potentially of great significance to the electoral process. The number of workers they employed accounted for more than 60 percent of total employees—that is, voters—in all industries. Furthermore, they were the traditional political supporters of the LDP (Allison 1993: 44; Pempel 1998: 165).³⁰⁸ Indeed, the LDP subcommittee in charge of banking policies had a strong interest in protecting SMEs.³⁰⁹

In consequence, the LDP were opposed to policies to strengthen the regulations related to bank capital adequacy, while demanding regulatory forbearance in order to raise banks' regulatory CARs and thereby increase loans to SMEs, even though the bank regulatory authority and opposition parties sometimes called for stricter regulation of banks.³¹⁰ One important event was the establishment of the Financial Inspection Manual in April 1998. In its initial plan of December 1997, the bank regulatory authority was to adopt stronger rules of asset classification and loan loss provisioning. However, the final version of the manual was substantially attenuated in those areas due to opposition from banks that warned of aggravation of the already-rampant credit crunch, and from the LDP that worried about this as well.³¹¹ Also, the LDP influenced the regulatory authority to postpone the implementation of the PCA system for domestic banks for one year until April 1999 and to change accounting rules in order to raise banks' CARs (*Asia Pulse* 24 December 1997). The government injected public funds to a total JPY 9.5 trillion to banks whose CARs were higher than the 8 percent minimum with the condition of the expansion of credit supply to SMEs, despite the objection from

³⁰⁸ For example, the construction industry, which was heavily in debt and lacked alternative sources of financing through capital markets, funnelled large amount of funds to the LDP. As a result, since the 1970s many had called Japan as “construction company” due to the massive amounts of public works spending carried out by the government (Amyx 2003a: 8-9, 26 n. 26).

³⁰⁹ Author's confidential interview with a senior BoJ official, Tokyo, 20 February 2004.

³¹⁰ The dominance by the coalition of opposition parties in the Upper House during the mid-1998 made a few progressive measures in banking supervision. However, banking policies quickly returned to regulatory forbearance once the LDP regained the majority with allies in the Upper House in late 1998.

³¹¹ Author's interview with Iwahara Shinsaku (Chair of the Work Group on Financial Inspection Manual), Tokyo, 16 February 2004. NPLs were concentrated in construction and real estate companies. As of end March 2001, these industries accounted for 54 percent of the outstanding balance of RMLs. Therefore, the close relations between the LDP and the industries were also likely to lead the LDP to oppose the idea of strengthening asset classification.

opposition parties (*The Asahi Shimbun* 23 February 1998; *Japan Economic Newswire* 12 October 1998).³¹² In addition, inspections of banks by the regulatory authority were carried out in a way that did not affect lending to SMEs.³¹³

Another salient episode demonstrating the failure of the regulatory authority's efforts to strengthen the capital adequacy regulations due to political intervention was the Programme for Financial Revival (PFR) of October 2002. As Japan's economy remained stagnant for more than a decade, the FSA, the BoJ, and a minority of the LDP perceived that the weak capital position of banks had a negative effect on the country's economic recovery.³¹⁴ As a result, from the early 2000s, they began to argue aggressively that the Japanese BIS standard was too lenient, and the FSA established the PFR to strengthen the soundness of Japanese banks.³¹⁵ In an earlier version of the PFR, the FSA planned to implement stricter rules on bank capital adequacy, including limiting DTAs to be counted as capital only to 10 percent of tier 1 capital. However, banks, fearing potential government intervention in their management, severely resisted the plan and warned of an extensive credit crunch.³¹⁶ Concerns over this led the majority of the LDP to block the implementation of the plans, and, as a result, the FSA postponed the announcement of the programme, indicating "political reasons" (*Financial Times* 23 October 2002).³¹⁷ The final version of the PFR was substantially eased down. The limited inclusion of DTAs in capital was abandoned, and detailed rules

³¹² Also, the LDP criticised a move by some local governments to set high capital adequacy standards for financial institutions, insisting that the trend further discouraged lending. In response, the central government promised to persuade local governments not to take such measures (*Japan Economic Newswire* 8 February 2002).

³¹³ Special inspections by the FSA from October 2001 to April 2002 were limited to major banks and their large borrowers, ignoring loans to SMEs, which accounted for 60 percent of lending by the major banks' (*The Times* 13 April 2002; FSA 2002). Also, the FSA kept arguing that the capital adequacy of Japanese banks was sound and their NPL problem would normalise gradually.

³¹⁴ They conceived that the weak capital position of banks hindered the banks from responding to the loose monetary policies of the BoJ.

³¹⁵ BoJ Governor Hayami Masaru triggered the controversy over capital adequacy standards in October 2001 at a Diet testimony by saying that major banks' CARs would only be around 7 percent at the end of fiscal year 2001 if calculated using the stricter standards employed in the United States (*Japan Economic Newswire* 21 November 2001). The Minister for Economics and Fiscal Policy Takenaka Heizo also called for the amelioration of the capital quality of banks (*Japan Economic Newswire* 23 February 2002).

³¹⁶ For example, Nishikawa Yoshifumi, President of Sumitomo Mitsui Banking Corporation, a major Japanese bank, told Financial Services Minister, Takenaka Heizo, in a meeting: "If you're going to change the rules overnight, I'm afraid it's very likely there'll be an extensive credit crunch" (*The Asahi Shimbun* 26 October 2002).

³¹⁷ Minister for the Economy, Trade and Industry, Hiranuma Takeo also described the proposals as "very severe" and argued that they "should not be implemented" before further discussion about soft landing measures (*Financial Times* 26 October 2002).

on DTAs and a specific timetable for launch were not made. Also, regional banks, whose clients mostly consisted of SMEs, were not affected by the PFR. Even then most of the announced plans were not implemented.³¹⁸

Banks or SMEs

One may question whether the LDP's opposition to strengthening the capital adequacy regulations was an attempt to protect banks rather than SMEs. In fact, banks have been one of the biggest financial contributors to the LDP throughout the postwar period, the Japanese Bankers Association (JBA) being ranked as the LDP's top three industry backers (Amyx 2003a: 9).³¹⁹ However, banks' ability to influence government policy was largely affected by their public reputation, along with the relative strength of any countervailing organised interests (Amyx 2003a: 10). Banks were heavily criticised by the public as the main culprit in the country's economic downturn throughout the 1990s and early 2000s. The public outrage directed at banks was more intensified due to bankers' salaries, which were far higher than the rest of the working population. In the meantime, the LDP was losing its seats in the Diet throughout the period. In the circumstances, it was almost political suicide for the LDP to support the unpopular banking sector.³²⁰

Moreover, the tension between the LDP and banks drastically rose after the resolution of the *jusen* problem in 1996. As mentioned earlier, in resolving the *jusen* problem, the government required banks, which were a major lender group of *jusen* companies to bear more than a pro rata share of losses, in favour of agricultural corporations, which was the other major lender group and which was a politically powerful group.³²¹ In addition, the LDP deflected public outrage at the use of public funds (USD 695 billion) in resolving the *jusen* problem from itself to banks and the MFJ by painting them as public enemies. The LDP pressured the heads of top banks to

³¹⁸ Author's interviews with Fukao Mitsuhiro (member of the Working Group on Bank's Capital Adequacy Ratios associated for the PFR), Tokyo 9 March 2004, and Okina Yuri, (member of the Working Group), Tokyo, 24 March 2004. The only significant measure implemented was the introduction of Discount Cash Flow methods on provisioning. However, their application was limited to major banks' large borrowers classified as "needs special attention".

³¹⁹ The huge amount of financial contributions from the JBA to the LDP were viewed largely as banks' efforts to impede the possibility of the Socialist Party, previously the largest Opposition force, coming to power (Amyx 2003a: 25 n. 17).

³²⁰ Traditionally, when bank interests conflicted with those of more electorally important constituencies, banks' interests were not favoured (Amyx 2003a: 10).

³²¹ Agricultural cooperatives derived their political influence from their ability to mobilise voters at elections (Amyx 2003a: 27 n. 35).

resign, to take responsibility for the *jusen* debacle, infuriating the banks. After the *jusen* resolution, the JBA ceased financial contributions to the party through the Japan Federation of Economic Organizations (Amyx 2003a: 10-11).

The injection of public funds into major banks whose BIS CARs were over 8 percent in the late 1990s was a prominent example of policies to protect SMEs at the expense of banks' interests. Banks were initially fiercely opposed to the injection of public funds because they were afraid of government intervention in their management and of a decline in their market image (*Japan Economic Newswire* 15 October 1998; *Financial Times* 18 February 1998). However, the LDP-led government forced banks to accept public funds, even by strengthening loan loss provisioning rules and launching inspections of banks to pressure them to apply for public funds. Finally banks reluctantly applied for public funds, and they were required to increase loans to SMEs.³²² Banks may have benefited from lax capital adequacy regulations, but the major reason for the LDP to exercise regulatory forbearance toward banks was to increase loans to SMEs.

To conclude, Japan's cosmetic compliance with the BIS standard during the PCA period is explained by the distributional effect of compliance with the BIS standard and the low independence of the regulatory authority from political influence. As banks reduced lending, costs of compliance with the BIS Standard diffused from banks to SMEs. As a result, the LDP was opposed to comprehensive compliance with the BIS standard in order to reduce the costs to SMEs, which were a politically important sector. Although the regulatory authority was willing to strengthen the capital adequacy regulations, their institutional arrangement made it vulnerable to political influence.

Conclusions

Japan's compliance with the BIS standard was a clear case of cosmetic compliance. As the financial condition of banks deteriorated, the government aggressively implemented policies that conflicted with the objective of the BIS standard, in order to lower the banks' costs of compliance with the BIS standard. External compliance pressures did force banks to comply with the BIS standard formally, but they were not effective in

³²² See *The Asahi Shimbun* (14 January 1998), FRC (1999a;1999b), *Mainichi Daily News* (16 October 1998), and *The Nikkei Weekly* (23 February 1998). The government also relaxed tough conditions on management responsibility and restructuring in order to induce banks to apply for public funds (*Asiaweek* 7 May 1999).

inducing comprehensive compliance. The Japanese regulatory authority faced the necessity of strengthening the capital adequacy of banks, as the soundness of the banking sector weakened while the convoy system was weakening. However, during the pre-PCA period, the country lacked an adequate financial safety net for political reasons. This induced the bank regulatory authority to exercise regulatory forbearance. This capacity problem was cured during the PCA period, yet compliance costs diffused from banks to SMEs, which was a politically important sector in the country. As a result, strong opposition from politicians to comprehensive compliance emerged in order to protect SMEs. Even though the regulatory authority was willing to strengthen the capital adequacy regulations, their low independence from the ruling party hindered them from doing so.

CHAPTER 6

South Korea: A Shift from Cosmetic to More Comprehensive Compliance

Korea's level of compliance with the BIS standard changed over time. External compliance pressure induced the country to adopt and comply with the BIS standard formally prior to the 1997 financial crisis. However, the weak link between compliance with the standard and prudential regulation in the country was reflected in the lenient implementation of the standard prior to the 1997 financial crisis. Yet, the financial crisis brought considerable changes and transformed the attitude of the Korean regulatory authority towards capital adequacy regulation. As a result, the country's level of compliance with the BIS standard became more comprehensive, even though compliance was not truly complete because of domestic opposition. Foreign countries and markets also played a role in improving the country's compliance with the BIS standard, but their effects were limited in comparison to impact of domestic regulatory pressures.

6.1 Compliance before the 1997 Financial Crisis

The BIS standard was introduced in Korea by the Korean regulatory authority due to their concerns for Korean banks' international business. The regulatory authority initially set the Korean BIS standard largely in accordance with the Basel Accord. Also, banks' formal compliance with the standard was remarkable during the pre-crisis period. However, as the financial condition of Korean banks was weakening, the regulatory authority implemented the BIS standard cosmetically by exercising regulatory forbearance. Meanwhile, external compliance pressures did not have much effect on Korean banks' compliance with the BIS standard, either formal or comprehensive.

The South Korean BIS Standard

As noted earlier, the Korean regulatory authority, the OBS, had no intention to

strengthen the domestic banking regulations by adopting the BIS standard.³²³ However, concern over Korean banks' international business led the regulatory authority to employ the BIS standard. Quoting from a former OBS official, the adoption of the BIS standard was "not a matter of choice but a must-do task" to protect the international business of Korean banks.³²⁴ The motivations for the regulatory authority's adoption of the BIS standard were articulated in a press release from the OBS in October 1991, which announced the country's plan to implement the BIS standard:³²⁵

As South Korea is not a member country of the Basel Committee, we have no obligation to adopt the BIS standard. However, we expect that major advanced countries may restrict the establishment of new branches by foreign banks that do not comply with the standard and also that banks which do not comply with the standard may face high costs of borrowing in international financial markets. Thus, we cannot help adopting the international standard as soon as possible for Korean banks' smooth operation of international business. (OBS 1991b)

The legal groundwork for incorporating the BIS standard into the country's banking regulations was laid by the amendment of the General Banking Act in December 1991. The amendment established a new article that required banks to maintain the soundness of management and empowered the competent authority, the OBS, to establish and impose prudential management guidelines for banks. The Korean BIS standard was finally established in July 1992 by the promulgation of the Prudential Management Guidelines for Banking Institutions and the Detailed Enforcement Regulations for Prudential Management Guidelines for Banking Institutions. The regulations required banks to maintain their BIS CARs above 7.25 percent from the end of 1993 and above 8 percent from the end of 1995.³²⁶

The Korean BIS standard of July 1992 was formulated largely akin to the Basel

³²³ Although the regulatory authority introduced a few measures to strengthen the soundness of the banking sector in the early 1990s, the adoption of the BIS standard was not a re-regulatory measure (author's confidential interview with a senior FSS official, Seoul, 28 January 2005).

³²⁴ Author's confidential interview with a senior FSS official, Seoul, 28 January 2005.

³²⁵ See also OBS (1990b: 40, 1992a: 55, 1994c: 5).

³²⁶ The regulatory authority had wanted to implement the BIS standard earlier than 1995 in order to prevent banks from facing difficulty in doing international business (Ha 1991: 4; OBS 1991b). However, the regulatory authority anticipated that banks' BIS CARs would fall below 8 percent unless the banks adjusted their behaviour (OBS 1991b; Song 1998: 14). Therefore, the regulatory authority implemented the BIS standard from 1993, but did so with a transitional period of the first two years.

Accord (see Table 6.1), although there were a few notable differences. Like the Japanese BIS standard, a risk weight of 10 percent was applied to claims on Korean public sector entities, excluding the central government or claims guaranteed by the central government or similar entities. Claims on the Korean government were treated in the same way as those of OECD countries, but such the practice of allocating a low risk weight for claims on the country's own central government was typical for non-OECD countries, as is also shown in the case of Taiwan.³²⁷ The BIS standard was applied to all commercial banks in Korea. In fact, the regulatory authority initially considered applying it first of all to banks with overseas branches (OBS 1992b). However, the authority changed its initial plan and applied the BIS standard to all commercial banks because the other banks were expected to more actively engage in international business as financial liberalisation further developed.³²⁸

Table 6.1 The Korean BIS Standard of 1992

A. Capital Elements

Tier 1

- (a) Paid-in capital
- (b) Capital reserves
- (c) Retained earnings (except declared but unissued stock dividends)
- (d) Minority interests in equity accounts of subsidiaries

Tier 2

- (a) Asset revaluation reserves
- (b) 45 per cent of unrealised gains on securities holdings (except those in the trust accounts)
- (c) Loan loss provisions

B. Deductions form the capital base

From tier 1

The amount equivalent to goodwill and consolidation adjustment debit, and the treasury stock account

From total capital

- (a) Investment in nonconsolidated subsidiaries engaging in financing business
- (b) Holdings of capital instruments issued by other banks. Where banks holdings of other banks' capital instruments bear a risk weight of 100 per cent, no deduction can be applied

C. Risk weights by category of on-balance-sheet asset

³²⁷ In addressing country transfer risk, the Korean BIS standard categorised countries into two groups: "First group" countries were composed of Korea, OECD countries and countries with General Arrangements to Borrow with the IMF, and all other countries were categorised as "second group" countries.

³²⁸ Author's confidential interview with a senior FSS official, Seoul, 16 February 2005. See also Song (1998: 15). In addition, the unitary application of the BIS standard reflected the regulatory authority's concern for the competitive disadvantages among banks in domestic markets (author's confidential interview with a senior FSS official, Seoul, 16 February 2005).

'First group' countries: Korea, OECD countries, and countries with General Arrangements to Borrow with the IMF

'Second group' countries: all other countries

0%

(a) Cash

(b) Claims on the central governments or the central banks of 'first group' countries and claims guaranteed by such entities

(c) Claims on the central governments or the central banks of 'the second group' countries denominated in national currency

(d) Claims collateralised by deposits in the lender's own account

10%

Claims on Korean public sector entities excluding central government or claims guaranteed by such entities

20%

(a) Claims on banks incorporated in 'first group' countries and claims guaranteed by such banks

(b) Claims of banks incorporated in 'second group' countries with a residual maturity of up to one year and claims with a residual maturity of up to one year guaranteed by such banks

(c) Claims on multilateral development banks (IBRD, IADB, AsDB, AfDB, EIB) and claims guaranteed by, or collateralized by securities issued by such banks

(d) Claims on public sector entities, excluding central government, of 'first group' countries, excluding Korea, and claims guaranteed by such entities

(e) Cash items in process of collection

50%

Loans fully secured by mortgage on residential property that is or will be occupied by the borrower or that is rented

100%

All other claims and assets

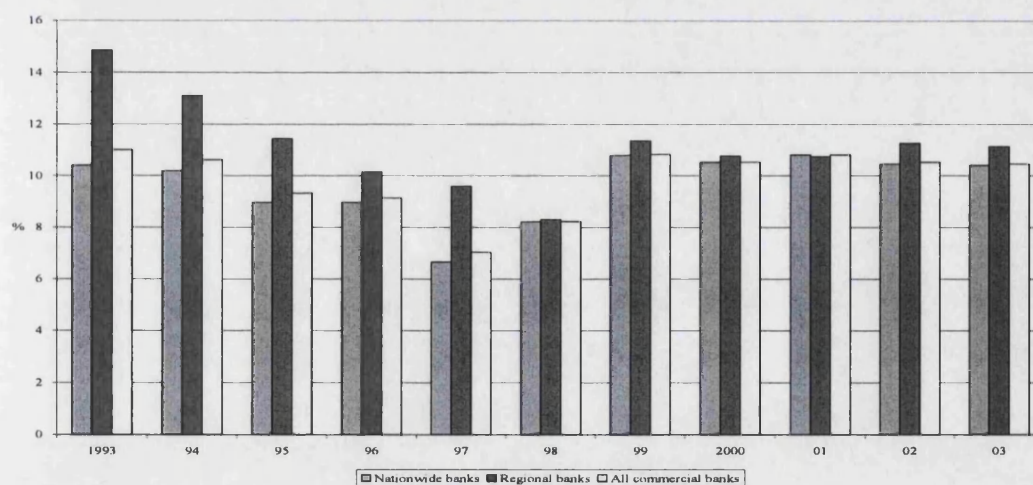
Source: Office of Bank Supervision, 30 July 1992, *Gumyung Gigwan Gyeongseong Jido Gwanhan. Gyujeong Sihaeng Sechig* (Detailed Enforcement Regulations for Prudential Management Guidelines of Banking Institutions).

In terms of conformity to the Basel Accord, the most controversial area was the treatment of loan loss provisions. The Korean BIS standard included all loan loss provisions in capital, which was inconsistent with the Basel Accord. However, the inclusion of special loan loss provisions in capital in the Korean BIS standard was not a deliberate measure by the regulatory authority to reduce the compliance costs of Korean banks, at least at *this* time. At the time, Korean loan loss provisioning rules did not divide loan loss provisions into general and special provisions. While banks were required to classify their assets into five categories ("normal", "precautionary", "substandard", "doubtful", and "estimated loss"), the only loan loss provisioning regulation was that a bank had to maintain a ratio of provisions to the sum of loans, payment guarantee, purchased foreign exchange and some other claims above 2 percent. There was no classification of loan loss provisions until the introduction of new provisioning rules in 1994 (OBS 1991a).

Formal compliance and domestic compliance pressure

The formal compliance of Korean banks with the BIS standard was almost perfect before the outbreak of the 1997 financial crisis. For the pre-crisis period, the average BIS CAR of all banks reached 11 percent at the end of 1993, and, even though it gradually declined, it stayed above 9 percent at the end of 1996 (see Figure 6.1).³²⁹ Moreover, although banks were required to maintain their BIS CARs over 7.25 percent during the transitional period of 1993 and 1994, all except one bank, whose BIS CAR was 7.62 percent at the end of 1993, kept their BIS CARs higher than 8 percent. Likewise, all but one bank, which was privatised in 1995, maintained their BIS CARs above 8 percent for 1995 and 1996.³³⁰ In addition, tier 1 capital ratio accounted for more than 80 percent of the total capital bases of Korean banks at the end of 1996 (Song 1998: 27).

Figure 6.1 The average BIS CAR of Korean banks, 1993-2003
(end of period; %)



Source: Office of Bank Supervision (1993-1998) and Financial Supervisory Service (1999-2003), various issues of *Unhaeng Gyeong-yeong Tonggae* (Bank Statistics).

Note: The calculation formula of the BIS CAR was strengthened from 1998.

³²⁹ Korean banks' disclosed BIS CARs were at the lowest level among Asian banks in the mid-1990s. At the end of 1995, the average BIS CAR of Singapore banks was 18.7 percent, followed by 17.5 percent of Hong Kong banks, 12.2 percent of Taiwanese banks, 11.9 percent of Indonesian banks, 11.3 percent of Malaysian banks and 9.5 percent of Indian banks. The ratio of Korean banks was 9.3 percent (*The Korea Economic Daily* 12 March 1997). These ratios did not necessarily reflect the actual capital soundness of the banks.

³³⁰ The BIS CAR of the bank that failed to meet 8 percent was 6.1 percent at the end of 1995, but had risen to 8.5 percent by the end of 1996.

This compliance record of Korean banks was in striking contrast to their shabby record of compliance with the previous capital regulations. Why did the banks respond to the BIS standard so differently from the previous regulations? The immediate factor was the threat of regulatory penalties from the domestic regulatory authority. Unlike the Japanese regulations, the 1991 amendment of the General Banking Act granted the Korean regulatory authority the legal power to punish banks that failed to comply with management guidelines.

The OBS could impose regulatory sanctions, Management Rationalisation Measures or Management Improvement Measures, for banks that failed to meet the required 8 percent minimum. Management Rationalisation Measures included improvement in personnel and/or organisational management, cost reduction, improvement in the management of business offices and restrictions on investments in fixed assets and/or new capital investment. Management Improvement Measures could be issued when a bank's BIS CAR was below 8 percent for more than two consecutive years, and they included capital increase, restrictions on distribution of dividends, accumulation of special loan loss provisions, closure or consolidation of business offices, restrictions on the establishment of new business offices, suspension of new capital investment, restrictions on holding risk assets and disposal of assets (OBS 1992c). In fact, the regulatory authority had discretion to exercise regulatory forbearance for noncompliant banks, and, moreover, they actually had little intention of penalising banks for noncompliance.³³¹ However, the overt presence of regulatory penalties for noncompliance with the BIS standard led banks to comply with the capital adequacy regulation.³³²

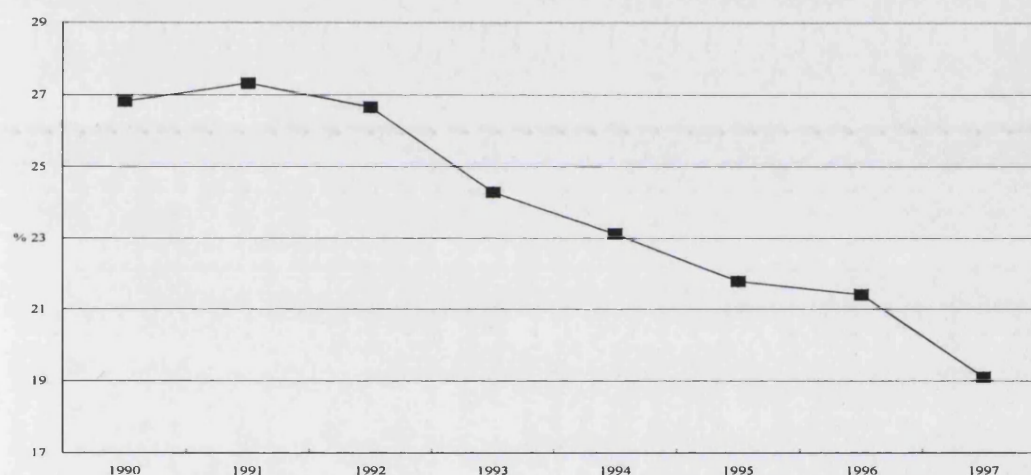
The salience of domestic regulatory penalties in inducing Korean banks' compliance with the BIS standard is confirmed by the fact that the banks did not make voluntary adjustments to improve their CARs until the official announcement of the implementation of the BIS standard by the OBS in October 1991. Responding to the announcement, Korean banks, for the first time, established measures to improve their CARs in their business plans for 1992 (Rym 1992). The ratio of loans and discounts in Korean won to the private sector in the banking account to total assets in nationwide banks, which were internationally more active than regional banks, showed an increase during 1991. However, the ratio began to fall from 1992 and declined more rapidly from

³³¹ Author's confidential interviews with senior FSS officials, Seoul, 15, 28 January 2005.

³³² Author's confidential interview with a senior banker of a major Korean bank, by phone, 26 August 2005.

1993, when the BIS standard officially took effect in the country (see Figure 6.2). Although Korean banks believed in the positive link between their compliance with the BIS standard and their international business activities, the compliance costs and a preparatory time to adjust their behaviour hindered them from improving their capital adequacy before the domestic adoption of the BIS standard.³³³ In fact, if BIS CARs of Korean banks had been computed in accordance with the provisions of the Basel Accord, the ratios of five out of the six largest Korean banks were lower than 8 percent in 1993 (NARK 1994a: 99).

Figure 6.2 The ratio of loans and discounts to the private sector to total assets for Korean nationwide banks, 1990-1997
(end of period; %)



Source: Office of Bank Supervision, various issues of *Unhaeng Gyeong-yeong Tonggae* (Bank Statistics).
Note: Loans and discounts to private sectors refer to those to corporations and households.

Cosmetic compliance and external compliance mechanisms

Although Korean banks were formally in compliance with the BIS standard, the BIS CARs of Korean banks were falling during the early and mid-1990s. This led the regulatory authority to actively help them maintain disclosed BIS CARs over the 8 percent minimum. The regulatory authority helped banks diversify capital-raising measures, for example, by allowing banks to issue overseas depository receipts and subordinated debt in 1996 and subordinated convertible bonds in 1997.³³⁴ The

³³³ Author's confidential interview with a senior banker of a major Korean bank, by phone, 26 August 2005.

³³⁴ See Ahn (1996: 39), *AsiaMoney* (December 1996), Song (1998: 27), NARK (1997: 61; 1999e: 3), and *Maeil Business Newspaper* (8 May 1997). Korean banks issued subordinated

regulatory authority also gave priority to banks with lower BIS CARs in raising equity capital in domestic markets (OBS 1993).

In addition, the regulatory authority implemented the BIS standard leniently in order to help banks formally maintain their BIS CARs over 8 percent (NARK 1999c: 3). Even though the regulatory authority adopted the “real BIS CAR” system in 1994, they did not implement it. The new provisioning rules, which required banks to provision 0.5 percent of their “normal” loans, 1 percent of “precautionary” loans, 20 percent of “substandard” loans and 100 percent of “doubtful” and “estimated loss” loans, were introduced in 1994, and the real BIS CAR was computed by subtracting provisions for “bad loans,” which referred to “doubtful” and “estimated loss” loans. The real BIS CAR system could have substantially increased the Korean BIS standard’s conformity to the Basel Accord, as a large part of special loan loss provisions were not included in the regulatory capital for the real BIS CAR.³³⁵ The regulatory authority planned to require that banks maintain their real BIS CARs above 8 percent from the end of 1994 and to take regulatory action against banks for noncompliance (OBS 1994b). However, as the capital condition of banks deteriorated, the regulatory authority did not disclose the real BIS CARs of banks, nor did they impose regulatory sanctions on banks for failure to comply with the real BIS CAR regulation.³³⁶

Also, as the financial condition of banks worsened due to a fall in stock prices, the regulatory authority allowed banks to recognise only 30 percent of unrealised losses on securities holdings for the book closings of 1995 and 1996 (OBS 1996c). According to an estimate, the disclosed BIS CARs of the banks were inflated by 0.23 and 0.84 percentage points in 1995 and in 1996 respectively, through the accounting change (Song 1998: 25-26).³³⁷

Furthermore, Korean banks were highly under-provisioned so that their BIS CARs

bonds in foreign currencies amounting to KRW 709 billion (2.7 percent of total capital) and borrowed subordinated debt amounting to KRW 772 billion (3.0 percent of total capital) in 1996, even though interest rates on subordinated bonds in foreign currencies were about 30 b.p. higher than those on floating rate notes (Song 1998: 26-27).

³³⁵ Loan loss provisions accounted for 62 percent of Korean banks’ tier 2 capital at the end of 1996 (Song 1998: 39).

³³⁶ Author’s confidential interviews with senior FSS officials, Seoul, 28 January 2005 and 18 February 2005. Also, note that the OBS did not disclose the volume of “substandard” loans because it worried that the disclosure could have a negative effect on the creditworthiness of banks (NARK 1992: 94).

³³⁷ In addition, as banks’ BIS CARs declined, the regulatory authority postponed the introduction of the 1996 amendment of the Basel Accord from 1996 to 2000 in 1996. The introduction of the 1996 amendment was expected to pull down BIS CARs of banks by about 0.4 percentage points.

were inflated. The asset classification rules were lenient and reduced the volume of provisions that banks had to build. Loans in arrears for more than three months but less than six months were categorised as “precautionary” loans, only 1 percent of which were required to be provisioned. Restructured loans, such as loans whose interest payment was suspended or reduced, were classified as “substandard”, just 20 percent of which were required to be provisioned (OBS 1996a: 25-26).³³⁸ In addition, the regulatory authority lowered the required level of provisions for “doubtful” loans from 100 percent to 75 percent as the financial condition of banks worsened (Ahn and Kim 1996: 51). As a result, a large proportion of impaired loans in banks were under-provisioned during the pre-crisis period (OBS 1994a, 1994b).³³⁹ Given that the amount of loan loss provisions surpassed 1.25 percent of the risk-weighted assets (Song 1998: 25), an increase in the required amount of loan loss provisions could have brought down banks’ disclosed BIS CARs through a fall in the tier 1 capital.³⁴⁰

In consequence, the disclosed BIS CARs of Korean banks failed to reflect their actual capital conditions. Table 6.2 shows the actual capital conditions of nationwide banks during the pre-crisis period. Real BIS CARs of more than about a quarter of the banks dropped below 8 percent from 1995. Assuming that they wrote off all “substandard” or below loans, the adjusted BIS CARs of the majority of the banks fell below 8 percent from 1994. Indeed, when banks were required to compute BIS CARs based on an upgraded standard requiring 100 percent provisions in the wake of the 1997 financial crisis, the BIS CARs of only twelve out of a total of twenty six commercial banks met the 8 percent minimum at the end of 1997 (OBS 1998).

³³⁸ In addition, banks provided new loans to firms that were unable to service their debt so that they could pay interest. This simple trick of “evergreening” enabled banks to turn distressed assets into performing assets (*The Korea Herald* 13 June 2000).

³³⁹ In 1996, only 29 percent of “substandard” or below loans were provisioned.

³⁴⁰ In 1996, banks recognised only 86 percent of their loan loss provisions as tier 2 capital because of the provision that limited the amount of loan loss provisions eligible for inclusion in tier 2 capital to 1.25 percent of the risk-weighted assets (Song 1998: 25).

Table 6.2 The actual capital conditions of Korean nationwide banks, 1994-1996
(end of period; %)

| | 1994 | | | 1995 | | | 1996 | | |
|------------------------------|-----------|-------|----------|-----------|-------|----------|-----------|------|----------|
| | Disclosed | Real | Adjusted | Disclosed | Real | Adjusted | Disclosed | Real | Adjusted |
| Cho Hung Bank | 10.07 | 9.03 | 3.08 | 9.01 | 8.14 | 2.44 | 8.48 | 7.83 | 3.55 |
| The Commercial Bank of Korea | 10.56 | 9.98 | -1.85 | 9.64 | N/A | N/A | 9.25 | N/A | N/A |
| Korea First Bank | 10.04 | 9.05 | 3.21 | 8.71 | 7.59 | 1.95 | 9.14 | 7.89 | 1.88 |
| Hanil Bank | 11.04 | 10.32 | 5.65 | 9.72 | N/A | N/A | 8.89 | N/A | N/A |
| Bank of Seoul | 10.62 | 8.25 | -0.29 | 8.97 | 6.21 | -0.51 | 8.56 | 5.93 | -2.65 |
| Korea Exchange Bank | 9.06 | 8.17 | 1.87 | 8.66 | 10.61 | 4.11 | 9.16 | N/A | N/A |
| Kookmin Bank | - | N/A | N/A | 6.06 | 5.81 | 4.01 | 8.46 | 8.16 | 6.44 |
| Shinhan Bank | 11.68 | 11.01 | 9.55 | 11.77 | 10.90 | 9.22 | 10.03 | 9.33 | 7.18 |
| KorAm Bank | 8.49 | 8.07 | 6.91 | 8.57 | 7.76 | 6.03 | 8.80 | N/A | N/A |
| Donghwa Bank | 12.39 | 11.33 | 9.60 | 10.64 | 9.57 | 7.91 | 9.48 | 8.50 | 6.85 |
| Dong Nam Bank | 9.53 | 8.69 | 7.05 | 8.61 | N/A | N/A | 8.76 | N/A | N/A |
| Dae Dong Bank | 9.20 | 8.24 | 6.76 | 8.39 | N/A | N/A | 9.07 | N/A | N/A |
| Hana Bank | 8.12 | 8.08 | 7.88 | 8.35 | 8.30 | 7.65 | 8.71 | 8.61 | 7.90 |
| Boram Bank | 8.92 | 8.79 | 8.06 | 8.68 | N/A | N/A | 8.70 | N/A | N/A |
| Peace Bank of Korea | 12.10 | 11.76 | 9.86 | 9.49 | N/A | N/A | 8.92 | N/A | N/A |
| Average | 10.13 | 9.34 | 5.53 | 9.02 | 8.32 | 4.76 | 8.96 | 8.04 | 4.45 |

Source: The author's own estimation from *Unhaeng Hyeonhwang* (Bank Management Report) of individual banks and various issues of *Unhaeng Gyeong-yeong Tonggae* (Bank Statistics) by Office of Bank Supervision.

Note: Real BIS CARs were estimated by subtracting provisions for "doubtful" and "estimated loss" loans from the capital bases; "adjusted" BIS CARs were estimated under the assumption that all "substandard", "doubtful", and "estimated loss" loans were written off.

Despite the cosmetic characteristics of Korea's compliance with the BIS standard during this period, there was no significant external pressure on Korean banks to improve their actual levels of capital adequacy. The inclusion of special provisions in the regulatory capital of the Korean BIS standard was a clear violation of the Basel Accord. However, as discussed in Chapter 4, the high costs of enforcement and the low negative externalities for foreign banks and countries that would be generated by Korea's cosmetic compliance with the BIS standard prevented foreign countries from exercising pressure on the Korean banks and the regulatory authority to comprehensively comply with the standard. The fact that Korea had no obligation to comply with the BIS standard may have even further reduced the incentive for foreign countries to put such pressure on the country, in the absence of perceived financial instability in Korea.³⁴¹ Indeed, Korean banks increased their overseas footholds—subsidiaries, branches, or representative offices—in Basel Committee countries, including the United States and the United Kingdom, and also in countries that required a minimum BIS CAR higher than 8 percent (for example, Hong Kong and Singapore) throughout the early and mid-1990s (see KFB 1998).³⁴²

There was also no substantial market pressure on Korean banks to improve their capital adequacy levels. For example, in spite of the deteriorating capital condition of Korean banks, their credit ratings, including stand-alone ones, were not downgraded until the actual outbreak of the 1997 financial crisis.³⁴³ Non-downgrading of the banks' traditional standard credit ratings, which took into account the probability of government support, may have resulted from the government's "no bank failure" policy. Under the policy, CRAs may have had less reason to monitor banks, given that it was costly to gather and analyse information (see Karacadag and Taylor 2000: 32-33). Yet, stand-alone ratings did not take into account the probability of government support, and

³⁴¹ After the 1997 financial crisis, as will be discussed in detail later in this chapter, the attitude of foreign countries towards the Korean practice of the BIS standard changed significantly.

³⁴² Hong Kong and Singapore set up a required BIS CAR minimum for domestic banks of 10 percent and 12 percent respectively. However, for example, the BIS CAR of a Korean bank (Boram Bank), which established an overseas branch in Hong Kong in November 1994 and an overseas representative office in Singapore in March 1997, was lower than 9 percent throughout 1994 to 1997 (KFB 1998).

³⁴³ For instance, from October 1995 to February 1997, the Moody's stand-alone rating (Bank Financial Strength Rating) remained stable at D+ for Cho Hung Bank and at D for Korea First Bank and Korea Exchange Bank. The ratings of Kookmin Bank and Shinhan Bank were stable at D+ from October 1995 to May 1998 and at C from October 1995 to December 1997, respectively. The ratings of KorAm Bank and Hana Bank did not change from D from June 1996 to December 1998. The ratings of Daegu Bank and Pusan Bank were unchanged at D+ and D respectively, from September 1996 to December 1997.

non-downgrading of Korean banks' stand-alone ratings was a vivid case of the analytical failure of the CRAs. Likewise, even though the disclosed BIS CARs and the actual capital condition of Korean banks declined between the end of 1993 and the first half of 1995, their overseas borrowing costs for floating rate notes dropped by about 10 b.p. on average during this period (Park 1996: 7).³⁴⁴ In fact, the failure to notice the true capital condition of Korean banks was common among most market participants prior to the 1997 financial crisis.

It may be asked whether a high proportion of tier 1 capital of Korean banks was a reflection of external pressures on them to strengthen their capital adequacy. However, a high level of tier 1 of Korean banks resulted from the small size of unrealised gains and the underdevelopment of other tier 2 capital instruments. Commercial and specialised banks' holdings of securities (excluding Monetary Stabilisation Bonds, whose risk weight was zero percent) accounted only for 7 percent of their total assets in June 1990 (BoK 1990: 50). Moreover, as stock prices declined, banks' holdings of securities negatively affected their CARs. Hybrid debt capital instruments and subordinated debt were not included as tier 2 capital in the 1992 Korean BIS standard, because they were not introduced in the country at that time.³⁴⁵

6.2 Regulatory forbearance during the pre-crisis period

Along with the absence of pressure, either domestic or external, for comprehensive compliance, the lack of capacity to deal with the negative consequences of banks' compliance failures on the overall economy was the main factor that explained Korea's cosmetic compliance with the BIS standard during the pre-crisis period. There were also other factors—the relationships between the MFK and banks and *chaebols*, the weakness of the formal financial safety net, concern regarding credit squeeze, the country's joining of the OECD and the BoK's obtainment of BIS membership—that seemed to affect the implementation of the BIS standard in the country. However, their

³⁴⁴ A floating rate note is a bond whose coupon (interest) rate is reset periodically, based on a benchmark short term interest rate, for instance, three month or six month LIBOR. Korean banks' costs of borrowing in international markets increased in the autumn of 1995 and remained high during the following year. However, this rise in the borrowing costs was attributable mainly to the emergence of a Japan Premium, over-competition for foreign funds among Korean financial institutions, and an increase in demand for foreign funds due to a rise in the size of the country's economy, rather than a decline in the banks' capital soundness (Kim 2003: ch. 5; Park 1996: 5).

³⁴⁵ As discussed above, as the financial condition of banks was weakening, the regulatory authority allowed banks to issue such capital instruments.

actual effects were limited.

Economic growth and regulatory emphasis on formal compliance

Korea's cosmetic compliance with the BIS standard was induced largely by the regulatory authority's emphasis on formal compliance in the absence of their strong intention to strengthen prudential regulation. Under the hierarchical structure of the MFK over the OBS, the adoption and implementation of the BIS standard was led by the MFK, whose priority was economic growth in administering financial policies, while the OBS constructed detailed rules in accordance with directions from the ministry.³⁴⁶ As a result, compliance with the BIS standard was treated by the regulatory authority from a macroeconomic perspective rather than as a prudential regulation. For the country's economic development, banks' compliance with the BIS standard was a critical issue because compliance failure could result in a systemic crisis, an increase in their costs of borrowing foreign capital.³⁴⁷

Traditionally, the country's economic development relied heavily on foreign capital. Domestic savings were well below investment levels, and therefore the gap between the level of domestic savings and the level of investments had to be filled by foreign capital (MFK and KDB 1993: 613; Cho and Kim 1997: 57-62) (see Table 4.3). According to an estimate (Cho and Kim 1997: 57), approximately 22 percent of total investment from 1962 to 1991 was financed by foreign capital, primarily by loans.³⁴⁸ The supply of foreign capital was also necessary for domestic firms to settle international trade, as the country's current account chronically recorded a deficit. The country enjoyed a current account surplus during a brief period from 1986 to 1989, when the reliance on foreign capital temporarily decreased. However, the current account balance turned to a deficit again from 1990 to 1997, with the exception of 1993, and firms suffered from a shortage of funds for investment. In addition, firms' demand for funds in foreign currency was rapidly rising from the late 1980s due to their increasing foreign direct investment.

Korean banks played an important role in providing foreign capital for economic

³⁴⁶ Author's confidential interviews with a senior MoFE official, Seoul, 21 February 2005, and a senior FSS official, Seoul, 16 February 2005.

³⁴⁷ Author's confidential interview with a former senior OBS official, Seoul, 3 February 2005. See also NARK (1996: 154) and OBS (1996b).

³⁴⁸ According to an estimate (Cho and Kim 1997: 102-103), while the average economic growth rate between 1962 and 1982 was 8.2 percent, the average growth rate during the period could have declined to only 4.9 percent without the supply of foreign capital.

development by borrowing directly from international financial markets (Cho and Kim 1997: 60). Foreign loans to Korean banks accounted for 22 percent of total medium and long-term capital (USD 80.2 billion) introduced into the country from 1962 to 1992, following commercial and public loans, which accounted for half the total amount (MFK and KDB 1993: 615). Banks held about 60 percent of the total foreign debt of the country at the end of 1997 (NARK 1999d: 89). Banks used most of their foreign borrowing in lending to domestic firms or in providing foreign exchange for settlement of international trade.³⁴⁹ Given the role of banks as an important provider of foreign capital to domestic firms, the regulatory authority had to help banks comply with the BIS standard formally, in order to reduce their costs of foreign borrowing.³⁵⁰

In addition, it was an important policy objective for the Kim Yong-Sam administration (1993 to 1997) to reduce firms' financial costs. As the country's economic growth became sluggish in the early 1990s,³⁵¹ the government understood that the economic slowdown was a result of the "high cost and low efficiency" structure of the economy (see MoFE 1997: 36, 42-46), and tried to strengthen "national competitiveness," which became the buzzword in the economy at the time.³⁵² Korean firms heavily relied on external funds (see Table 6.3), and as a result they paid high financial costs. Their ratio of interest expenses to sales reached 5.5 percent in 1995, which was far higher than that of their Japanese (1.3 percent) or Taiwanese competitors (2.2 percent). High financial costs of the firms were pointed out as a major factor in the weakening of Korean firms' competitiveness vis-à-vis their foreign competitors.³⁵³ A further increase in the financial costs for businesses that would have resulted from the downgrading of Korean banks' creditworthiness in international markets had to be prevented for economic growth reasons.³⁵⁴

³⁴⁹ For example, 36 percent of foreign capital in domestic branches of banks was lent to firms—mostly domestic firms—and 32 percent was provided for settlement of international trade in 1993, while less than 5 percent of the foreign capital was invested in securities in foreign currency (Chae 1994).

³⁵⁰ Author's confidential interviews with a senior FSS official, Seoul, 16 February 2005, and a senior MoFE official, Seoul, 21 February 2005.

³⁵¹ The economic growth rate declined to less than 3 percent in the early 1990s, while the Korean authorities regarded 7 percent as the proper level of economic growth at that time (NARK 1999g: 106-107).

³⁵² See EPB (1994: 350-351) and Kim (1999: 452-453). The government launched a campaign of "10 percent increase in competitiveness" (MoFE 1996: forewords).

³⁵³ Author's confidential interview with a senior MoFE official, Seoul, 21 February 2005. See also EPB (1993: forewords) and MoFE (1995: 217-230, 1997: 336-343).

³⁵⁴ As mentioned earlier, Korean banks' costs of international borrowing increased in late 1995 and in 1996. See note 344.

Table 6.3 Debt ratios of manufacturing firms by country, 1990-1993
(%)

| | 1990 | 1991 | 1992 | 1993 |
|---------------|-------|-------|-------|-------|
| Korea | 286.3 | 309.2 | 319.7 | 294.9 |
| Japan | 227.1 | 221.0 | 216.4 | 212.8 |
| Taiwan | 83.4 | 97.9 | 93.0 | 88.0 |
| United States | 148.7 | 147.3 | 168.2 | 174.5 |

Source: Bank of Korea, various issue of *Gi-eop Gyeongyeong Beunseok* (The Analysis of Firms' Statistics).

In the circumstance, as BIS CARs of Korean banks were declining, the regulatory authority implemented the BIS standard leniently in order to ensure banks' formal compliance with the BIS standard and thereby help economic growth. A former OBS official commented: "The adoption of the BIS standard was meaningless if banks failed to comply with the standard [because the implementation of the BIS standard was to protect banks' international business]."³⁵⁵ At this point, it should be noted that there was no resistance from the OBS to the lax implementation of the BIS standard nor was there any voice from the OBS about strengthening the Korean BIS standard.³⁵⁶ As discussed earlier, the lack of the independence of the OBS from the MFK and the presence of the "no bank failure policy" hindered the OBS from attaching priority to prudential regulation during the pre-crisis period.

Other sources of lax implementation of the BIS standard

There are some other factors worth analysing for their effects on the implementation of the BIS standard in the country. Kim Yong-Ki (2003), among others, argues that the MFK had cosy relationships with banks and *chaebols*, and that these cosy relationships hindered the effective regulation of the banking sector. The cosy relationship between the MFK and banks was obvious. One prominent example was *naghasan yinsa*, which matched *amakudari* in Japan: high-ranked MFK officials were typically re-employed for three years in high profile private sector institutions controlled by the ministry—for example, nationwide banks—and thereafter they worked for another three years for less prominent private sector institutions—for example, regional banks or president of

³⁵⁵ Author's confidential interview with a senior FSS official, Seoul, 28 January 2005.

³⁵⁶ In the wake of the 1997 financial crisis, Lee Hen-Jai, former Chairman of the FSC, commented: "[i]n hindsight the previous financial administration looks a mess, but, to be honest, it was not regarded as problematic at that time" (NARK 1999f: 2).

merchant banks (Kim 2003: 80-82).³⁵⁷

However, most former MFK officials who were reemployed in banks took the position of auditors, and their major roles were to hide the banks' problems from the regulatory authority's inspections, or lobby for the individual banks (NARK 1999h: 50). In other words, the main negative result of the cosy relationships between the MFK and banks was the inefficient supervision or inspection of banks' compliance. Yet, the first problem in the implementation of the BIS standard in the country was not supervision of banks' compliance but the laxity of the capital adequacy standard and other related accounting rules themselves. In addition, at the time, banks had little autonomy in their management, and they usually followed government policies.³⁵⁸ In the circumstances, the lax regulations in regard to the BIS standard were not likely to be a result of regulatory capture by banks.

Nor did the MFK appear to relax capital adequacy rules to benefit *particularly* large businesses (*chaebols*), which had powerful leverage over public policy due to their oligopolistic position across the economy.³⁵⁹ From the late 1980s, in response to increasing social demands for equity, income distribution and balanced growth under political democratisation in progress, the priority of credit policies shifted from *chaebols* to previously disadvantaged sectors such as SMEs. The government adopted several measures to encourage banks to lend to SMEs, while intensifying credit control over large business groups, in order to ease the concentration of bank loans to *chaebols* (Cho and Kim 1997: 18, 45-47, 104-106; Haggard 2000: 28-29; Hahm 2003: 82-84; Wad 2002: 185). Consequently, the share of loans to SMEs as a percentage of total loans by commercial banks increased from 48 percent in 1988 to 56 percent in 1995, while the share of loans to the top thirty *chaebols* decreased from 24 percent in 1988 to 14 percent in 1995 (Hahm 2003: 85). Likewise the government treated SMEs more favourably than *chaebols* in policies regarding loans in foreign currency (BoK 1995; see NARK 1994b). Therefore, the likelihood that the regulatory authority implemented the BIS standard leniently to help supply of foreign capital exclusively for *chaebols* was not high.³⁶⁰

³⁵⁷ Formal high-ranked BoK or OBS staff members were also re-employed in private financial institutions, although their number was smaller than former MFK officials (Kim 2003: 81-82).

³⁵⁸ See Chapter 3 (section 3.2).

³⁵⁹ The performance of the national economy was largely influenced by the performance of *chaebols*.

³⁶⁰ As banks' lending to *chaebols* declined, they began to depend more on non-bank financial institutions, which were increasingly under their control as an alternative financing source. In addition, they could raise funds in international capital markets without government help, due to

The next factor to examine is the country's financial safety net, given that the absence of an adequate financial safety net could have hindered the regulatory authority in implementing the BIS standard more strictly. The Korea government did not have formal mechanisms for closing ailing banks during the pre-crisis period, as shown by the fact that a deposit insurance system was not introduced until 1997. However, the absence of such mechanisms was a reflection of the government policy that did not allow banks to fail. Moreover, the regulatory authority thought that, although a large number of banks failed to meet the BIS standard, it would not cause a systemic financial crisis.³⁶¹ The regulatory authority's belief had reasonable grounds: the capital liberalisation of the country was still in its early stages until it joined the OECD in 1996;³⁶² in addition, the government had maintained a sound budget (see Table 5.4), unlike the Japanese or Taiwanese governments. Therefore, the absence of an adequate formal financial safety net was not a significant factor that led the regulatory authority to exercise regulatory forbearance in implementing the BIS standard.

Concern regarding a potential credit squeeze was another potential factor that may have hindered the country's comprehensive compliance with the BIS standard. The regulatory authority's decision to begin to implement the BIS standard from the end of 1993, one year later than the deadline for Basel Committee countries, partly reflected their concern for a decline in credit supply from banks (NARK 1992: 94). Also, the regulatory authority worried that a stricter implementation of the BIS standard might have caused a credit squeeze in the economy.³⁶³ Given Korean firms' high debt ratio, the regulatory authority's concern was reasonable. Yet, a credit crunch was a *secondary* concern for the regulatory authority in implementing the BIS standard. Their primary concern was to ensure the smooth supply of foreign capital.³⁶⁴ In fact, a reduction in credit supply by commercial banks was partly compensated for by an increase in credit supply from specialised banks, which were not subject to the BIS standard.³⁶⁵ In addition, it is worth noting that, during the pre-crisis period, politicians did not raise questions regarding the negative effects of the implementation of the BIS standard on banks or on the overall economy. Politicians' focus in regard to the BIS standard was on the negative consequences for banks if they failed to comply with it, although they did

their reputation and creditworthiness (Cho and Kim 1997: 16-17; Hahm 2003: 85-86).

³⁶¹ Author's confidential interviews with a senior MoFE official, Seoul, 21 February 2005, and senior FSS officials, Seoul, 28 January 2005 and 16 February 2005.

³⁶² Author's confidential interview with a senior MoFE official, Seoul, 21 February 2005.

³⁶³ Author's confidential interview with a senior FSS official, Seoul, 31 January 2005.

³⁶⁴ Author's confidential interview with a former senior OBS official, Seoul, 3 February 2005.

³⁶⁵ Author's confidential interview with a senior MoFE official, Seoul, 21 February 2005.

not exercise pressure on the country's capital regulations.³⁶⁶

The last factor to consider is the country's joining of the OECD and the BoK's acquirement of a full membership of the BIS. The BoK obtained membership in September 1996, and Korea became an OECD member in December 1996. The country's compliance with the BIS standard might have helped it obtain the membership by improving its image as an advanced country. However, the introduction and implementation of the BIS standard was not directly related to those events.³⁶⁷ While the plan to adopt the BIS standard was announced in 1991, the government established a plan to obtain OECD membership between 1992 and 1994 (NARK 1999a: 45) and the BoK began to strive for BIS membership from around 1993 (*The Korea Economic Daily* 18 June 1993; BoK 1994: 39).

6.3 The 1997 financial crisis and the IMF

The 1997 financial crisis shifted Korea's compliance with the BIS standard from cosmetic to more comprehensive compliance. After the financial crisis, the government embarked on financial restructuring, which included the strengthening of the Korean BIS standard to conform to the Basel Accord, and upgraded the accounting rules that influenced the effectiveness of compliance with the BIS standard. Given that Korea was under the influence of the IMF at this time and up until 2000, the improvement in the country's compliance with the BIS standard, on the surface, seemed to be attributable to IMF pressure. However, closer examination of the implementation of the BIS standard during the IMF period shows that the role of the IMF was limited in strengthening the country's compliance with the BIS standard.

The IMF programme

The outbreak of the 1997 Asian financial crisis, which involved Korea, imposed significant costs on the world economy. The crisis accelerated major countries' concerted action to strengthen financial regulation at the international level, which had

³⁶⁶ It should be stressed that the BIS standard had not attracted much attention from politicians, including members of the Finance Committee in the National Assembly, until the 1997 financial crisis occurred.

³⁶⁷ Author's confidential interviews with a former senior OBS official, Seoul, 3 February 2005, and senior FSS officials, Seoul, 28 January 2005, and 18 February 2005.

been developing substantially after the 1995 Mexican peso crisis.³⁶⁸ The crisis countries' lax prudential regulation—in particular, their weak compliance with international standards—was pointed out as a main cause of the financial crisis. A 1998 IMF report (IMF 1998) on the strengthening the international monetary system argued:

A key lesson from the Asian crisis is the urgent need to strengthen domestic financial systems, including particularly prudential regulation. ... There is an urgent need to further develop and disseminate internationally accepted standards—in areas such as accounting, auditing, bankruptcy and corporate governance—to encourage good practices and to allow financial markets to differentiate better across borrowers.

In short, the financial crisis radically increased the incentives for countries to force others'—in particular, the crisis countries'—comprehensive compliance with the BIS standard.

In the meantime, Korea's seeking assistance from the IMF provided the latter with the means to induce the country to comply with the BIS standard comprehensively. Korea entered into a stand-by arrangement with the IMF on 4 December 1997, through it received a USD 57 billion loan from the IMF. When a country borrowed from the IMF, its government had to make commitments on economic and financial policies—a requirement known as conditionality. These policies constituted the country's "policy programme," which was described in a letter of intent (to which a memorandum of economic and financial policies was often attached) that accompanied the country's request for IMF financing. Most IMF loans featured phased disbursements so that the IMF could verify that a country continued to adhere to its commitments before disbursing successive instalments (IMF 2005).

Under the IMF programme (December 1997 to August 2000), the Korea government upgraded banking regulations to meet the Basel Core Principles, including the strengthening of the Korean BIS standard to conform to the provisions in the Basel Accord. Specific loan loss provisions—provisions against "substandard", "doubtful", and "estimated loss" loans—were no longer counted as tier 2 capital (GRK 1998a, 1998c). Assets in all trust accounts with guarantee, of which risk weight had been 10 percent, were risk-weighted at 50 percent in 1999 and at 100 percent in 2000 (*The Korea Economic Daily* 19 August 1998; GRK 1998a).

³⁶⁸ After the financial crisis, the FSF was initiated by the G7 countries. On the Forum, see Chapter 1 (section 1.2).

Asset classification standards and provisioning rules were strengthened. A Forward Looking Criteria (FLC) method, which required banks to base their risk management and provisioning on borrowers' ability to service their obligations in the future, was incorporated into the asset classification rules in 1999 (FSC 1999: 30). In addition, the existing backward-looking criteria were strengthened. Loans in arrears for one to three months were classified as "precautionary" loans, and loans in arrears for three to six months as "substandard" loans. Restructured loans could be categorised at best as "precautionary", with prompt reclassification to "substandard" or below on evidence that the borrower could not fully perform their obligations under the restructuring agreement (GRK 1999). Provisioning rules were strengthened so that banks were required to maintain full provisioning for their impaired assets and for their securities holdings.

The new financial regulatory authority, the FSC, and its executive arm, the Financial Supervisory Service (FSS), employed the BIS CAR as the criteria in restructuring the banking sector (GRK 1998a). Under the first round of financial restructuring, which was completed by the end of September 1998, five (three nationwide and two regional banks) out of a total of twelve undercapitalised banks were either closed or merged with stronger ones (in June 1998) (FSC 2000). Moreover, although the formally required minimum BIS CAR was 8 percent, the minimum target ratio of banks was 10 percent in practice; the remaining seven undercapitalised banks were encouraged by the regulatory authority to increase their BIS CARs to 10 percent by December 2000 (GRK 1998b).³⁶⁹ A PCA system based on the BIS CAR and the CAMEL rating was implemented in April 1998 so that banks with a BIS CAR below 8 percent faced automatic regulatory penalties, which included the closure of the bank (see FSS 2005).³⁷⁰ As a result, Korean banks had to comply with the strengthened BIS standard, desirably with a BIS CAR over 10 percent, at all costs to survive or to avoid regulatory sanctions from the regulatory authority. Indeed, although two Korean banks failed to clear the required minimum CAR of 8 percent in 1999, all Korean banks met the requirement between 2000 and 2003, and most Korean banks maintained their BIS CARs above 10 percent between 1999 and 2003 (see Figure 6.1).

³⁶⁹ The government required banks to raise their BIS CARs to above 10 percent as new NPLs could arise (NARK 1999b: 10).

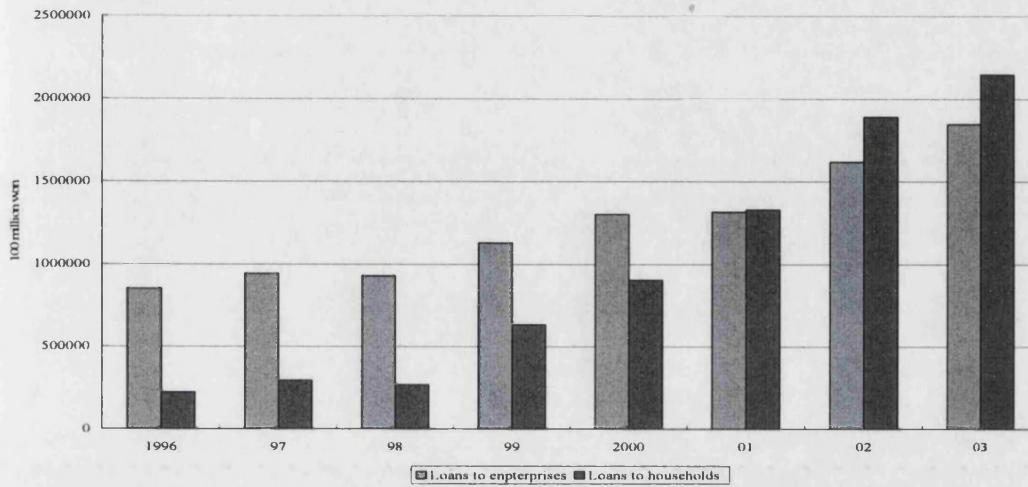
³⁷⁰ The CAMEL rating was a bank rating scheme whose components consisted of capital adequacy, asset quality, management, earnings, and liquidity.

The limitations of the role of the IMF

Yet, even though the international community had a strong incentive to pressure Korea to strengthen the soundness of its financial system and an official means was available to do so, the IMF conditionality, it would be misleading to argue that the role of the IMF—in other words, foreign pressure—was foremost in strengthening Korea's compliance with the BIS standard. As will be discussed in the next section, the Korean regulatory authority had a strong motivation and desire to improve Korean bank capital adequacy standards and regulations. In addition, as the implementation of the IMF programme gave rise to enormous domestic opposition, the Korean government negotiated with the IMF to relax its requirements, thereby responding to domestic demand.

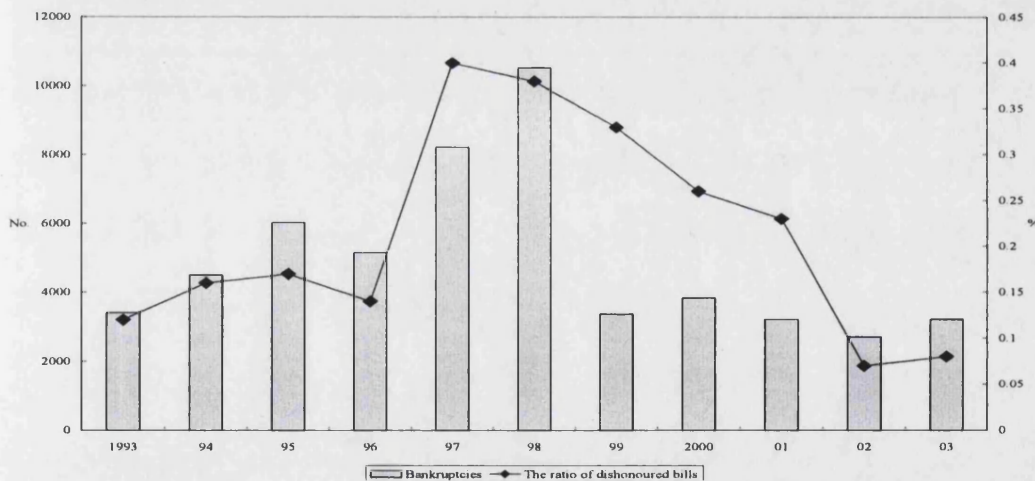
During the first round of financial restructuring, Korean banks rapidly curbed loans to firms in order to meet the required 8 percent minimum (see Figure 6.3), and this caused a severe credit crunch, which lasted until the autumn of 1999 (MoFE 1999: 126; Choi 2000). The number of bankruptcies of firms soared to about 10,500 in 1998 from about 5,200 in 1996 (see Figure 6.4), and it generated much unemployment. As a result, the implementation of the BIS standard—along with the tight monetary policy—was heavily criticised as the main culprit. The Korean Chamber of Commerce and Industry (KCCI), which represented the interests of the overall corporate sector, called for a flexible application of the BIS standard in order to avoid bankruptcies of viable firms (*The Korea Herald* 14 August 1998). Also, the United Liberal Democrats, the coalition partner of the ruling party, demanded that the government ease the BIS standard to mitigate the credit crunch (*The Korea Times* 11 October 1998).

Figure 6.3 Loans and discounts in won by Korean commercial banks, 1996-2003
(end of period; KRW 100 million)



Source: Financial Supervisory Service, various issues of *Unhaeng Gyeong-yeong Tonggae* (Bank Statistics).

Figure 6.4 Bankruptcies of Korean firms, 1993-2003
(end of period; number; %)



Source: Korea Federation of Small & Medium Business, 2004, *Jeungsogi-eop Hyeonhwang* (Statistics of Small & Medium Enterprises); Financial Supervisory Service, various issues of *Monthly Financial Statistic Bulletin*.

This severe credit crunch led the government to object to the drastic strengthening of prudential regulations and to negotiate with the IMF to relax its requirements.³⁷¹ The government persuaded the IMF to advance the timeframe for computing BIS CARs of banks for the first financial restructuring retroactive to the end of 1997 (*Maeil Business*

³⁷¹ Author's confidential interviews with senior FSS officials, Seoul, 31 January 2005 and 15 February 2005.

Newspaper 11 January 1998; *Asia Pulse* 12 January 1998; GRK 1997;1998c). The government and the IMF agreed to give banks two years to meet the BIS standard, instead of the initial plan of six months (*AFX News* 13 January 1998), and to allow a further delay for banks with little international business (GRK 1998b).³⁷² The government prevailed on the IMF to allow banks to classify loans to “work-out” firms as “precautionary” instead of the initial plan of “substandard” (*Maeil Business Newspaper* 9 February 1999) and to postpone recording financial institutions’ losses that were generated by work-out borrowers from June 2000 to December 2000 (*The Seoul Economic Daily* 30 June 2000; *Maeil Business Newspaper* 5 July 2000).³⁷³ In November 1998, the government created a new provision that allowed supervisors to postpone issuing a PCA order for a specified period of time when they expected that banks could satisfy required standards (FSS 2005). The regulatory authority did not impose sanctions on the failure to meet the target BIS CAR of 10 percent.³⁷⁴ The government wanted to delay the introduction of the FLC for one year, although the plan was rejected by the IMF (*The Korea Economic Daily* 5 November 1998; *Maeil Business Newspaper* 30 June 1999); yet, the FSS announced that it would exercise forbearance by not issuing a PCA order to banks whose BIS CARs fell below 8 percent, because of the application of the FLC, if their restructuring plans were acceptable (*The Korea Times* 28 June 2000; *The Korea Herald* 13 June 2000).

In addition, the government injected public funds of KRW 64 trillion amounting to 14 percent of the GDP into the financial sector in 1998 (earlier than planned) in order to ease the credit crunch (*The Korea Times* 31 August 1998; MoFE 1999: 100). Banks that received public funds were obliged to include programmes to expand corporate loans in their rehabilitation plans. Previously, the FSC had required the banks to include only programmes for layoffs, branch reductions, management changes and capital reductions (*The Korea Times* 16 September 1998).³⁷⁵ Also, there was a suspicion that the government did not fully disclose the impaired assets in banks, given that the BIS CARs

³⁷² As a result, seven out of twelve undercapitalised banks announced a stop in international business (*Maeil Business Newspaper* 23 June 1998).

³⁷³ The government estimated that the BIS CARs of banks would fall by 1 to 2 percentage points if the loans were categorised as “substandard” (*Maeil Business Newspaper* 9 February 1999). Also, it was anticipated that the BIS CARs of five commercial banks would fall below 8 percent if the losses were recorded for the book-closing of June 2000 (*The Seoul Economic Daily* 30 June 2000, 5 July 2000).

³⁷⁴ Author’s confidential interview with a senior FSS official, Seoul, 31 January 2005.

³⁷⁵ By 2003 most banks that received public funds were privatised with the exceptions of Woori Financial Holdings, Korea First Bank, Cheju Bank and Seoul Bank (MoFE and PFOC 2003: 191).

and net asset values of six banks that received public funds in the second round of financial restructuring, which began in September 2000, suddenly became negative (*The Seoul Economic Daily* 19 December 2000).³⁷⁶

In summary, the IMF did not have the omnipotence to force Korea to follow its policy recommendations. In fact, the limitations of the IMF in implementing its policy programmes despite its superior leverage over borrowing countries have been indicated by a number of studies on IMF conditionality. These studies suggest that even though governments favoured the IMF agreements ex ante, domestic political constraints force governments to not fully implement such agreements. These studies also suggest that without country ownership of IMF programmes—a firm commitment from the government and other relevant constituencies—the programmes are less likely to be implemented.³⁷⁷ Apparently, Korea's compliance with the BIS standard was improved to some extent under the IMF programme. However, this change was largely attributable to the operation of the domestic compliance mechanism after the financial crisis, which will be discussed in the following section.

6.4 The domestic compliance mechanism after the crisis

The financial crisis generated a domestic group that attached priority to prudential and effective financial regulation, including comprehensive compliance with the BIS standard. Although Korea was under the influence of the IMF during the IMF programme, strengthening of the country's financial regulations was in practice driven by the domestic group. The significance of the domestic compliance mechanism in strengthening Korea's compliance with the BIS standard becomes clear when comparing compliance with the BIS standard under the IMF programme with that of the post-IMF period. However, the diffusion of BIS standard compliance costs from banks to firms through a decline in bank loans and the limited independence of the regulatory authority from the government led the regulatory authority to exercise forbearance to some extent, preventing truly comprehensive compliance with the BIS standard.

³⁷⁶ The disclosed BIS CARs of the six banks were 8.7, 10.4, 5.2, 8.3, 7.6, and 12.4 percent at the end of 1999, and their net asset values were 2,245 billion, 438 billion, 28 billion, 5 billion, 5 billion, and 131 billion at the end of September 2000 (*The Seoul Economic Daily* 19 December 2000).

³⁷⁷ See, for example, Kahler (1993) and Khan and Sharma (2001).

The operation of the domestic compliance mechanism

The financial crisis did change the attitude of the Korean regulatory authority towards prudential regulation.³⁷⁸ The pre-eminent goal of financial reforms in the wake of the financial crisis was to avoid its recurrence. As a result, Korean authorities began to recognise the financial industry, whose main function had been to assist the growth of the real economic sector, as an independent industry and put great emphasis upon prudential regulation in order to normalise the role of financial institutions (see MoFE 1998: 162-197, 1999: 95-106). In addition, the authorities explicitly pointed out the lenient implementation of the BIS standard in addressing the causes of the 1997 financial crisis:

... The biggest changes in the Korean economy from the mid-1990s were the liberalisation of foreign exchanges and the internationalisation of financial institutions. ... However, regrettably a financial regulatory system to cope with the new environment was not established. ... The calculation method of the BIS CAR, which was the most important regulation to ensure the soundness of banks' assets, was expedient on several accounts. (MoFE 1998: 168)

The new financial regulatory authority, the FSC, and its executive organ, the FSS, were established in April 1998 and January 1999 respectively, in order to achieve efficient and appropriate financial supervision and regulation. The new regulatory authority emphasised the importance of the conformity of the Korean BIS standard with the Basel Accord to strengthen the banking regulatory framework (NARK 2001: 69, 73, 92). Indeed, "conformity with international standards" became the buzzword in financial regulation after the financial crisis.³⁷⁹ In short, the crisis provided the Korean financial regulatory authority the impetus required to improve domestic banking regulation, since the crisis itself was partly attributable to their policy failure.³⁸⁰

³⁷⁸ Prior to the 1997 financial crisis, the regulatory authority adopted an increasing number of prudential regulatory measures, which included a plan to upgrade banking regulations to conform to the Basel Core Principles by the end of 2000 (OBS 1997). However, these were mainly to strengthen the competitiveness of banks under the financial liberalisation in progress, with little intention to improve banks' soundness (BoK 1997; see OBS 1994b).

³⁷⁹ Author's confidential interviews with senior FSS officials, Seoul, 15 February 2005, and 18 February 2005. Also see MoFE (1998: 162-197, 1999: 95-106).

³⁸⁰ There was no drastic change in the personnel of the regulatory authority. Those who participated in negotiations with the IMF were mostly existing MFK or OBS officials (author's confidential interviews with senior FSS officials, Seoul, 31 January 2005 and 16 February 2005).

Learning occurred for the Korean regulatory authority due to the crisis.

One may raise the question whether the Korean regulatory authority could have strengthened the country's compliance with the BIS standard without external pressure from the IMF, given the significant domestic opposition to the strengthening of prudential regulation. Yet, after the end of the IMF programme in August 2000, the country's compliance with the BIS standard did not retreat to pre-crisis levels.³⁸¹ The strengthened Korean BIS standard and the relevant regulations were largely maintained, even though the regulatory authority exercised some degree of forbearance.³⁸² The BIS CARs of Korean banks remained at a level of 10 percent, the same as they were under the IMF programme (see Figure 6.1). Meanwhile, the actual capital soundness of the banks appears to have been higher during the early 2000s than during the IMF programme; Table 6.4 shows that Korean banks' ratio of loan loss provisions to NPLs steadily improved throughout the late 1990s and the early 2000s, suggesting that disclosed BIS CARs of Korean banks generally reflected their actual capital adequacy. Indeed, in 2003, the IMF Financial System Stability Assessment on Korea commented: "[the country's] capital requirements for banks are broadly in line with the Basel capital standard" (IMF 2003c: 35).

Table 6.4 Loan loss provisions ratios of Korean banks, 1994-2003
(end of period; %)

| | To NPLs | To substandard and below loans |
|------|---------|--------------------------------|
| 1994 | 20.7 | N/A |
| 1995 | 25.4 | N/A |
| 1996 | 28.8 | N/A |
| 1997 | 24.8 | N/A |
| 1998 | 48.4 | N/A |
| 1999 | 75.4 | 46.3 |
| 2000 | 86.5 | 64.6 |
| 2001 | 92.2 | 80.1 |
| 2002 | 91.3 | 88.0 |
| 2003 | 128.4 | 84.6 |

Source: The author's calculation from Financial Supervisory Service, various issues of *Unhaeng Gyeongyeong Tonggye* (Bank Statistics).

Note: NPLs herein referred to loans overdue more than six months ("substandard" or below loans under the old asset classification rules) until 1999. From 1999 NPLs included loans overdue more than three months and non-accrual loans (bankrupt loans, loans to borrowers whose capacity to repay was weakened, and non-performing restructured loans).

Also, officials in the OBS and in the MFK later moved to the new financial regulatory bodies; to the FSS and to the secretariat of the FSC.

³⁸¹ The Korea government's obligatory policy of consulting with the IMF ended in August 2000, when the government redeemed all the stand-by loans to it.

³⁸² As noted earlier, regulatory forbearance also existed under the IMF programme. Regulatory forbearance during the early 2000s will be discussed later in the following section.

This record of Korea's compliance with the BIS standard during the early 2000s is remarkable, given that domestic opposition to strict implementation of the BIS standard during this period was as strong as, or even more than, it was under the IMF programme.³⁸³ As the second round of financial restructuring began in September 2000,³⁸⁴ banks that worried about their charters again became reluctant to make loans to corporations in order to maintain their BIS CARs above 10 percent (see *The Korea Herald* 5 June 2000; MoFE 2002: 123). This caused a serious credit squeeze in the economy, affecting both SMEs and larger firms (see Figure 6.3).³⁸⁵ The impact of a decrease in bank loans on SMEs was enormous, as bank lending was almost the only credit supply for SMEs.³⁸⁶ Larger firms also suffered from a sharp decline in bank loans, and they, in addition, faced a capital market crunch at the time (MoFE 2001: 49, 54, 2002: 12, 123).³⁸⁷ As a result, most major actors in the economy, including both SMEs and big businesses, called for the relaxation of the implementation of the BIS standard.³⁸⁸ In addition, BoK Governor Chon Chol-Hwan explicitly expressed opposition to the unitary application of the BIS standard to banks without international business (*Maeil Business Newspaper* 18 January 2001), even questioning the desirability of the application of the regulatory standard, which was set by developed countries, to less developed countries (*The Korea Times* 13 January 2001, 18 January 2001). The opposition party also attacked the government by arguing that the unitary application of the BIS standard was a "socialist policy" (*The Korea Economic Daily* 2 August 2001). The fact that the country's compliance with the BIS standard did not

³⁸³ Public criticism of the credit crunch under the IMF programme was directed at both the tight monetary policy and the strict implementation of the BIS standard. However, by the end of the 1990s, the government normalised its monetary policy, and, as a result, interest rates began to decline from mid-1998 (MoFE 1998: 204, 211, 1999: 126). Accordingly, strict implementation of the BIS standard was perceived by the public to be the main culprit for the credit squeeze during the early 2000s.

³⁸⁴ The government carried out the second round of financial restructuring to normalise financial institutions in the wake of the bankruptcy of Daewoo, one of the top *chaebols*. The financial restructuring was completed by late 2001.

³⁸⁵ Most firms were negatively affected by the credit crunch during the late 1990s. Yet, the financial condition of larger firms was relatively better than SMEs at the time because banks favoured lending to larger firms than SMEs and also because larger firms could rely on direct financing to some extent.

³⁸⁶ The ratio of bank loans to total borrowing amounted to more than 80 percent for manufacturing SMEs (Kookmin Bank 1999).

³⁸⁷ According to a poll conducted by a local newspaper (*JoongAng Ilbo*), twenty six out of the country's top thirty *chaebols* were locked in a capital crunch (*Asia Pulse* 22 June 2000).

³⁸⁸ See, for example, *Asia Pulse* (16 May 2001), KCCI (2001), and *The Seoul Economic Daily* (8 December 2000).

substantially worsen, or even appeared to improve, after the departure of the IMF despite such strong domestic opposition to the strict implementation of the BIS standard clearly demonstrates that pressure from the IMF was not the critical factor to explain the strengthening of compliance during the post-crisis period.

Factors that hindered more comprehensive compliance

There are some important questions that remain to be answered regarding Korea's compliance with the BIS standard during the post-crisis period. Even though the country's compliance during this period was far higher than during the pre-crisis level, the Korean regulatory authority, as indicated earlier, exercised forbearance during the IMF programme period and also during the post-IMF period. Examples of regulatory forbearance during the post-IMF period were as follows: a guideline to lower the target BIS CAR for banks without international business to 6 percent was issued in July 2001 (*Maeil Business Newspaper* 11 July 2001); the risk weight of bonds guaranteed by the Seoul Guarantee Insurance Company was lowered from 100 percent to 50 percent in September 2001 (*FSS Weekly Newsletter* 25 August 2001); the FSC expressed that it would not penalise banks for failure to meet the required minimum CARs during the second round of financial and corporate restructuring (*The Korea Herald* 14 October 2000); and in July 2002, the FSC introduced a plan to allow banks to use average stock prices instead of the market prices for calculating the BIS CARs (*The Korea Economic Daily* 23 July 2002).³⁸⁹

Accordingly, one may question whether the improvement of Korean banks' compliance was attributable to market pressure rather than enforcement by the regulatory authority. However, as discussed in Chapter 4 (section 2), markets did not credit the BIS standard with a reliable regulation. There were general market pressures on Korean banks to improve their soundness in the wake of the financial crisis. However, such market pressures were not directly related with compliance to the BIS standard. For instance, Brian Oak, who was responsible for the Korean banking sector at Moody's, commented in August 2000:

The BIS CARs of banks rarely affect their credit ratings. Because the government

³⁸⁹ The FSC also delayed the implementation of the 1996 amendment of the Basel Accord from the end of 2000 to the first quarter of 2001, as the implementation was expected to drop banks' BIS CARs by 0.2 to 0.3 percentage points (*Maeil Business Newspaper* 18 January 2001). See also note 45 for the implementation of the 1996 amendment in Korea.

requires banks to increase BIS CARs, it is important for the banks to do so. However, asset quality is a more important factor to affect credit ratings (*The Seoul Economic Daily* 3 August 2000).

Even though most Korean banks maintained their BIS CARs above 10 percent, higher than the required minimum of 8 percent, this was mainly attributable to potential penalties from the regulatory authority. As indicated above, the target BIS CAR proposed by the Korean regulatory authority was 10 percent in practice throughout most of the late 1990s and the early 2000s. In fact, along with the measure to lower the target BIS CAR for banks without international business to 6 percent, the regulatory authority temporarily lowered the BIS CAR to be rated the highest grade in the CAMELS ratings below 10 percent, to 8 percent in 2001 and to 9 percent in 2003 (*Maeil Business Newspaper* 25 July 2003; FSC 2001a, 2001b; NARK 2001: 88, 92, 2003: 39-40).³⁹⁰ However, the closure of a massive number of banks by the government during the two rounds of financial restructuring gave Korean banks a firm incentive to maintain their BIS CARs above 10 percent to reduce the possibility of closure.³⁹¹ In addition, banks with a BIS CAR lower than 10 percent were restricted to engage in potentially lucrative business such as insurance.³⁹² Markets might provide banks an incentive to keep their capital soundness in the wake of the financial crisis, but, under the presence of strong pressure from the regulatory authority on banks to maintain their capital soundness, such market pressures appeared to be contributing factors rather than the major incentive for the banks to maintain their capital soundness.³⁹³

This leads to the question why did the Korean regulatory authority exercise forbearance, if it put great emphasis on banks' comprehensive compliance with the BIS standard? It should be emphasised that the regulatory authority's emphasis on the capital soundness of Korean banks was real. For example, in September 2002, the FSC established a plan to require banks to raise their tier 1 ratios over 5.5 percent (initially over 6 percent) by setting aside reserves equivalent to 10 percent of their earning every year to meet the ratio, although it subsequently abolished the plan due to government

³⁹⁰ The CAMELS system added sensitivity to market risk to the CAMEL system.

³⁹¹ The number of Korean banks declined from thirty-two to twenty-two between the late 1997 and November 2000 (FSC 2000).

³⁹² The FSC prohibited banks from engaging insurance business unless their BIS CARs were over 10 percent in August 2000 (*The Seoul Economic Daily* 11 August 2000).

³⁹³ Also, see Chapter 4 (section 4.3) for an analysis of banks' perception of market compliance pressures for the BIS standard.

opposition.³⁹⁴ In fact, most regulatory forbearance by the regulatory authority during the early 2000s was led by the government, especially the MFK. For instance, the 2001 guideline to lower the target BIS CAR for banks without international business to 6 percent was led by the ruling party and the MFK (*Maeil Business Newspaper* 11 July 2001). The introduction of the plan to allow banks to use average stock prices in July 2002 aimed to support and strengthen the stock market, a policy objective of the MFK, not the FSC (*The Korea Economic Daily* 23 July 2002). Also, the temporary lowering of the BIS CAR to be rated the highest grade in the CAMELS ratings in 2001 and in 2003 was agreed in the Financial Policy Council, a discussion channel for the MFK, the FSC, and the BoK, in order to induce banks to make more loans to firms (FPC 2001).³⁹⁵ In other words, the regulatory forbearance by the FSC during the early 2000s was largely a result of government interference over the FSC's regulatory policies.

During the late 1990s and the early 2000s, the Korean government was sandwiched between on the one hand firms demanding that the government increase bank credit and on the other hand banks that refused to cooperate with government policies for supplying credit to the firms.³⁹⁶ Furthermore, as the economy continued to be sluggish, support for the government was dwindling. According to a survey conducted by a local newspaper, approval ratings for President Kim Dae-Jung sharply declined to 20 percent at the end of 2000 from a high of 70 percent (*The Nikkei Weekly* 19 February 2001). In response, the government began to put growing emphasis on economic recovery and implementing the BIS standard leniently in order to facilitate economic recovery, and to prevent aggravation of an economic recession.³⁹⁷

³⁹⁴ The FSC established the plan as Moody's had placed Korean banks' stand-alone rating at seventieth on a list of seventy-nine countries in June 2002, and sixty-fourth out of eighty countries in September 2002. The plan was rejected by the Regulatory Reform Committee, which was directly accountable to the President (*The Korea Herald* 16 September 2002, 29 October 2002, 15 November 2002).

³⁹⁵ Also, the MFK led the increase of the risk weight of home mortgage loans from 50 to 60 percent in order to cope with sharply-growing household debt, in spite of opposition from the FSC, which worried about a fall of banks' BIS CARs (*The Korea Herald* 12 October 2002).

³⁹⁶ The traditional relationship between government and banks had unravelled because of the financial crisis and the subsequent financial restructuring. Through the first round of financial restructuring about 45,000 employees of financial institutions (more than 30 percent of the total) were laid off. Consequently, bank unions were strongly opposed to government intervention in the management of banks, arguing that it was the government that had forced banks to extend loans to unhealthy firms during the pre-crisis period (*Business Korea* August 2000). As a result, direct intervention from the government in the operation of banks virtually disappeared after the financial crisis, and the government could no longer compel banks to extend loans to the corporate sector.

³⁹⁷ A prominent example of policies that promoted the economy at the expense of financial regulation was credit card policy in the early 2000s. See Kim (2004a: 68-82, 111).

Government intervention in regulatory policies of the FSC was effective due to the limited independence of the FSC from the government, especially from the MFK. The key objective in establishing the FSC was to improve its independence from government, especially from the MFK. As a result, the FSC was legally granted operational autonomy, although it was located under the office of the Prime Minister.³⁹⁸ The main focus of the FSC was on financial regulatory and supervisory functions rather than various interests of the national economy, although it was also responsible for the restructuring of the corporate sector in the wake of the financial crisis.³⁹⁹ However, the independence of the FSC—and the FSS—was in practice undermined by its institutional characteristics. The Chairman was a cabinet member, which had the potential to jeopardise the independence of the FSC. Some in the FSC itself thought that the chairmanship had been politicised (Walter forthcoming). Indeed, despite the three-year tenure of the Chairmanship, there had been four Chairmen in six years by the end of 2003. Also, six out of a total of nine Commissioners were government or semi-government officials, and this structure of the FSC weakened the independence of the FSC (Kim 2004b).⁴⁰⁰ Although the MFK was required to consult with the FSC when it established or amended financial supervisory laws, the authority of the MFK in establishing and amending financial supervisory laws in practice hampered the FSC in implementing regulatory measures; cases which could be dealt with regulations from the FSC were sometimes handled by Enforcement Ordinances, for which the competent authority was the MFK, on the ministry's insistence (Kim 2004a: 101). In addition, legal protection for FSC/FSS staff against lawsuits for supervisory actions was not sufficient, and this had the potential to hamper the independence of regulators (IMF 2003c: 24, 35).

³⁹⁸ The Chairman, who concurrently held the position of the Governor of the FSS, was appointed by the President through deliberations in a Cabinet council. The Chairman's tenure of office was legally secured for three years and was renewable once, unless he or she could not perform the required duties due to mental or physical disability or violated obligations under the law governing the organisation of the FSC. Also, the FSS had sufficiently well trained staff to carry out their responsibilities, although there were indications of shortages of expertise in a few areas (IMF 2003c: 24).

³⁹⁹ Regulatory forbearance by the FSC may also have been partly attributable to its responsibility for corporate as well as financial restructuring. These two objectives had the potential to conflict with each other, leading the FSC to compromise with what might have been appropriate from a purely prudential regulatory perspective (IMF 2003c: 24; Walter forthcoming).

⁴⁰⁰ The nine members were the Chairman, the Vice-Chairman, the Vice-Minister of the MFK, the Deputy Governor of the BoK, the President of the Korea Deposit Insurance Corporation (KDIC), a financial expert recommended by the Chairman of the FSC, an accounting specialist recommended by the MFK, a legal expert recommended by the Ministry of Justice, and a representative of the business sector recommended by the President of the KCCI.

Furthermore, the size and the functions of the secretariat of the FSC, which was a normal (not independent) government agency, had been substantially enlarged through the four reorganisations that had taken place since its establishment. The number of the secretariat staff increased from 19 to about 130, about half of whom were government officials. The secretariat was initially intended to help the operation of the FSC, but it grew to become almost another financial regulatory authority, which had two financial supervisory policy bureaux. Furthermore, the power to govern the secretariat was in the hands of the MFK so that the growth of the secretariat resulted in a rise of the influence of the MFK on the operation of the FSC.⁴⁰¹ Conversely, the enlargement of the secretariat resulted in the impotence of non-standing Commissioners.⁴⁰² Indeed, in discussions as to how to reform the FSC during the early 2000s, there was a strong voice to abolish the secretariat, which was regarded by many Koreans as a pawn of the MFK, in order to increase the independence of the FSC (see Kim 2004b; NARK 2004: 51, 69).

The institutional arrangements of the FSC seriously undermined its independence from government, especially from the MFK.⁴⁰³ A senior official of the task force for the reorganisation of the FSC/FSS commented in a National Assembly hearing (NARK 2004: 50-51): “The impartiality [of the FSC] could continue to be a problem, because, given the relation between the FSC and the MFK, it is very difficult for the FSC to object to policies of the MFK.” The MFK occasionally intervened in financial regulatory policies to help its macroeconomic policies (NARK 2004: 103-105). As a result, when the regulatory policies of the FSC conflicted with other government policies, priority was frequently given to the latter.⁴⁰⁴

To conclude, regulatory forbearance by the Korean regulatory authority in the area of bank capital adequacy regulation during the post-crisis period was largely attributable to domestic opposition to strict implementation of the BIS standard and the limited independence of the regulatory authority from government. The regulatory authority put growing emphasis on comprehensive compliance with the BIS standard after the

⁴⁰¹ The MFK obtained the power to govern the secretariat by an irregular amendment of relevant laws (Kim 2004b).

⁴⁰² Three Commissioners who were not government officials were not engaged in all four reorganisations of the secretariat, nor were they given an *ex post facto* report (Kim 2004b).

⁴⁰³ Kim Hong-Beom (2004a: 12) argues that during the post-crisis period, the institutional setting in financial administration was in practice a vertical institutional hierarchy with the MFK on the top. The MFK, the argument goes, established policy directions and then other authorities, the FSC/FSS, BoK and KDIC, carried out policies according to the directions.

⁴⁰⁴ Author’s confidential interview with a senior FSS official, Seoul, 31 January 2005.

experience of the financial crisis. Indeed, the country's compliance with the BIS standard during the post-crisis period was far improved compared with the pre-crisis period. Yet, the heavy domestic opposition to strict implementation of the BIS standard gave the government a strong incentive to ease levels of implementation and compliance. The limited independence of the regulatory authority from the government allowed government intervention in regulatory policies. As a result, the regulatory authority could not strengthen the country's compliance further, despite its own willingness to do so.

Conclusions

Korea's compliance with the BIS standard during the pre-crisis period demonstrates the effect of external compliance pressure and its limitations. The Korean regulatory authority adopted the BIS standard and helped the banks maintain formal compliance because of concerns that noncompliance by banks would have adverse consequences for their international business. However, there were no external compliance pressures on Korea to comply with the BIS standard comprehensively. Meanwhile, the Korean regulatory authority had no intention of earnestly complying with the BIS standard. As a result, as the financial condition of Korean banks weakened, the BIS standard was implemented leniently in order to ensure formal compliance, thereby avoiding negative consequences for the economy as a whole due to the banks' compliance failure.

The country's compliance improved significantly during the post-crisis period. The Korean BIS standard was strengthened to be largely in line with the Basel Accord, and accounting rules that affected the effectiveness of the standard were also upgraded. As a result, Korean banks' actual capital adequacy levels were significantly improved. Pressure from the IMF and from the markets made some contribution to this shift in the country's compliance. However, the major factor explaining the improvement of the country's compliance with the BIS standard was the operation of the domestic compliance mechanism. The financial crisis changed the attitude of the Korean regulatory authority towards the importance of prudential regulation, leading them to put unprecedented emphasis on comprehensive compliance with the BIS standard.

Obviously, the regulatory authority exercised forbearance to some extent in regulating bank capital adequacy levels even during the post-crisis period. Compliance efforts by Korean banks caused firms to suffer from a decline in bank loans. This gave rise to strong domestic opposition to strict implementation of the BIS standard, thereby

politicising compliance with the BIS standard. The government responded to this domestic demand by intervening in regulatory policies to relax the implementation of the BIS standard. The government intervention in regulatory policies was effective due to the limited independence of the regulatory authority from the government. Yet, it would be misleading to argue that the regulatory authority failed to strengthen the country's compliance with the BIS standard during the post-crisis period. The country's compliance during the early 2000s did not shift to pre-crisis levels, nor was it lower than the compliance levels under the IMF programme.

CHAPTER 7

Taiwan: Weakening Comprehensive Compliance

Contrary to the Japanese and the Korean regulatory authorities, the Taiwanese regulatory authority had the intention of using the BIS standard to strengthen the soundness of the banking sector when they adopted it. As a result, Taiwan's initial compliance with the BIS standard was more comprehensive than in Japan or Korea. Also, Taiwanese banks' formal compliance was largely attributable to compliance enforcement from the domestic regulatory authority, although external compliance pressures also gave incentives for banks to comply with the BIS standard. Yet, Taiwan's compliance became cosmetic from the mid-1990s onwards. The country's compliance failure during this period mainly resulted from systemic capacity problems, which were mainly generated by domestic politics.

7.1 Compliance costs

The Taiwanese regulatory authority adopted the BIS standard both to ensure the stability of the banking sector and to maintain Taiwanese banks' international business. The intention of the Taiwanese regulatory authority to maintain the stability of the banking sector by adopting the BIS standard was reflected in the Taiwanese BIS standard, which was constructed largely in accordance with the Basel Accord. As a result, there was no arbitrary provision in the Taiwanese BIS standard to inflate the BIS CARs of Taiwanese banks. The costs for Taiwanese banks of complying with the BIS standard were, in general, not high, although they had to adjust their behaviour in order to meet the required minimum CAR of 8 percent. However, the compliance costs of Taiwanese banks rose sharply from the late 1990s and remained high during the early 2000s, as their financial condition weakened and as the government forced them to dispose of their NPLs.

The construction of the Taiwanese BIS standard

When the BIS standard was adopted in Taiwan, Taiwanese banks had to adjust their

behaviour in order to comply with it, even though the adjustment was not likely to be very costly. The author's rough estimation based on the comparison of Taiwanese banks' net worth ratios and BIS CARs in 1993 shows that the BIS CARs of major Taiwanese banks—government-owned commercial banks—was on average about 6.8 percent in 1988 (see Table 7.1).⁴⁰⁵ This ratio was lower than the required 8 percent minimum or the corresponding figure for Japanese or U.S. banks (9.6 and 8.8 percent respectively),⁴⁰⁶ although it was higher than that of Korean banks (4.6 percent) (see OBS 1990b).⁴⁰⁷ Therefore, Taiwanese banks' compliance with the BIS standard would not be automatic, even though their compliance costs were not likely to be significant.⁴⁰⁸

Table 7.1 Estimated BIS CARs of Taiwanese banks in 1988
(end of period; %)

| | 1988 | | 1993 | |
|-----------------------------------|-----------------|-------------------|-----------------|---------|
| | Net worth ratio | Estimated BIS CAR | Net worth ratio | BIS CAR |
| Government-owned commercial banks | 4.1 | 6.8 | 5.9 | 9.8 |
| Specialised banks | 5.9 | 9.3 | 5.9 | 9.3 |
| Private banks | 5.7 | 8.1 | 7.0 | 10.0 |

Source: The author's own estimation from Central Bank of China, various issues of *Jinron Jigou Yewu Gaikuang Nianbao* (Financial Institutions Business Operation Annual Report).

Note: Private banks do not include new private banks established after the 1989 amendment of the Banking Law.

Nevertheless, the adoption of the BIS standard in Taiwan preceded quickly, equivalent to its implementation in Basel Committee countries.⁴⁰⁹ The principles of the Basel Accord were incorporated into the country's banking regulations by the amendment of the Banking Law in July 1989. Article 44 of the amendment required Taiwanese banks to maintain their capital to risk-weighted assets ratios at no less than 8

⁴⁰⁵ As discussed in Chapter 3 (section 3.3), the capital levels of major Taiwanese banks were not high by international standards during the late 1980s.

⁴⁰⁶ As indicated earlier, the comparison of disclosed BIS CARs across countries does not necessarily reflect the actual capital soundness of banks in the countries. Nevertheless, the disclosed BIS CARs can show the relevant costs of the banks to comply with the required minimum BIS CAR of 8 percent.

⁴⁰⁷ However, Korean nationwide banks' BIS CAR rose to 13.6 percent in 1989 (OBS 1990b).

⁴⁰⁸ In fact, the Taiwanese regulatory authority did not expect that Taiwanese banks would face serious difficulty in meeting the BIS standard, although there were a few weakly-capitalised banks (author's interview with Wang Jiunn-Chih).

⁴⁰⁹ As indicated earlier, although some Taiwanese banks were initially opposed to the adoption of the BIS standard, they withdrew their opposition as foreign regulatory authorities required Taiwanese banks seeking to expand operations in the countries to submit their BIS CARs.

percent and empowered the competent regulatory authority, the MFT, to penalise banks that did not meet the ratio. Detailed rules governing the calculation of the BIS CAR were issued in April 1992 by the promulgation of 'Rules Governing the Coverage, Calculation Method of Owned Capital and Risk-Weighted Assets and Limitation to Distribution of Earning for Those Without Meeting the Standard.'⁴¹⁰ Although the rules were announced in the three years after the 1989 amendment, they took effect on promulgation so that Taiwanese banks were required to comply with the BIS standard from 1992 as was the case for banks in Basel Committee countries.

The Taiwanese regulatory authority formulated the Taiwanese BIS standard akin to the Basel Accord, reflecting their intention to maintain the stability of the banking sector by implementing it (see Table 7.2). Some categories of assets which were not on the list of risk-weighted asset categories in the Accord were allocated risk weights of less than 100 percent. Such assets were a bank's claims collateralised by deposits in the bank and claims guaranteed by credit guarantee bodies established by the government. Zero percent risk weight was allocated to the first category and 20 percent to the second category. In a strict sense, these assets should have been allocated a 100 percent risk weight according to the Accord. However, the zero percent application could be justified given that the risk of loss was extremely low for the assets in the first category. Also, the 20 percent risk weight seemed to be plausible, as the credit guarantee bodies were public sector entities backed by the central government, which maintained its credit ratings at an 'AA' level.⁴¹¹ As in Japan and Korea, a risk weight of 10 percent was allocated to claims on Taiwanese public sector entities excluding central government or claims guaranteed by such entities or claims collateralised by securities issued by such entities; and 45 percent of unrealised gains on securities holdings were included in tier 2 capital.⁴¹² Yet, in contrast to Japan and Korea, all Taiwanese banks, including specialised banks, were subject to the BIS standard.⁴¹³

⁴¹⁰ The English title of the regulation has grammatical problems, but it is the one used by the BoMA.

⁴¹¹ Taiwan's sovereign rating was AA+ by S&P's in December 1992, and it was Aa3 by Moody's in March 1994.

⁴¹² The inclusion of 45 percent of unrealised gains on securities holdings in the regulatory capital was to help banks—particularly government-owned banks—to meet the required 8 percent minimum (author's interview with Wang Jiunn-Chih). However, this capital element accounted for a trivial portion of the total capital bases of Taiwanese banks. This issue will be discussed later in this chapter.

⁴¹³ It is misleading to argue that Taiwanese authorities constructed the Taiwanese BIS standard more strictly than other countries based on the unitary application of the BIS standard to all Taiwanese banks. In fact, most of the countries that adopted the BIS standard applied it to all (commercial) banks; a country that applied it only to international banks—for example, Japan—

Table 7.2 The Taiwanese BIS standard of 1992

A. Capital elements

Tier 1

- (a) Common stockholder's equity
- (b) Non-cumulative perpetual stock
- (c) Capital reserves (except fixed asset revaluation reserves)
- (d) Retained earnings
- (e) Minority interests in equity accounts of subsidiaries
- (f) Cumulative effect of equity adjustments

Tier 2

- (a) Cumulative preference shares
- (b) Fixed asset revaluation reserves
- (c) 45 per cent of unrealised holding gains of long-term equity investments
- (d) Operation reserves
- (e) Convertible debt securities and allowances for loan and lease losses (except the reserves created against identified losses).

B. Deductions from the capital base

From tier 1: Goodwill

From total capital: Banks' holdings of equity capital issued by other banks

C. Risk weights by category of on-balance-sheet asset

0%

- (a) Cash
- (b) Claims on the central Taiwanese government and the central bank or claims guaranteed by such entities
- (c) Claims on OECD central governments and central banks or claims guaranteed by such entities
- (d) Claims on non-OECD central governments and central banks denominated in national currency, and
- (e) claims collateralised by cash, deposits in the lender's own account, securities issued by the Taiwanese central government or central bank securities or securities issued by OECD central governments or central banks.

10%

- (a) Claims on the Taiwanese public sector entities excluding central government or claims guaranteed by such entities
- (b) Claims collateralised by securities issued by the Taiwanese public sector entities excluding central government.

20%

- (a) Claims on multilateral development banks and claims guaranteed by, or collateralised by securities issued by such banks
 - (b) Claims on banks incorporated in the OECD and claims guaranteed by such banks
 - (c) Claims on banks incorporated in countries outside the OECD with a residual maturity of up to one year and claims with a residual maturity of up to one year guaranteed by such banks
 - (d) Claims on non-OECD public sector entities, excluding central government, and claims guaranteed by such entities
 - (e) Claims on Taiwan banks or claims guaranteed by those banks
-

was exceptional. In addition, contrary to Korea, most specialised banks engaged in commercial banking in Taiwan (BoMA 1992: 1). The unitary application of the BIS standard in Taiwan was partly to level the playing field for domestic banks (Author's confidential interview with a senior BoMA official, Taipei, 2 November 2004).

(f) Export negotiation and remittance purchased
(g) Claims guaranteed by credit guarantee entities authorised by the Taiwanese government
50%
Loans secured by mortgage on residential property.
100%
All other claims and assets

Source: Bureau of Monetary Affairs, *Jinrong Fagui Tonghan Huibian (Di-er-ji)* (Series of Financial Regulations (the 2nd series)).

The changing financial condition of banks

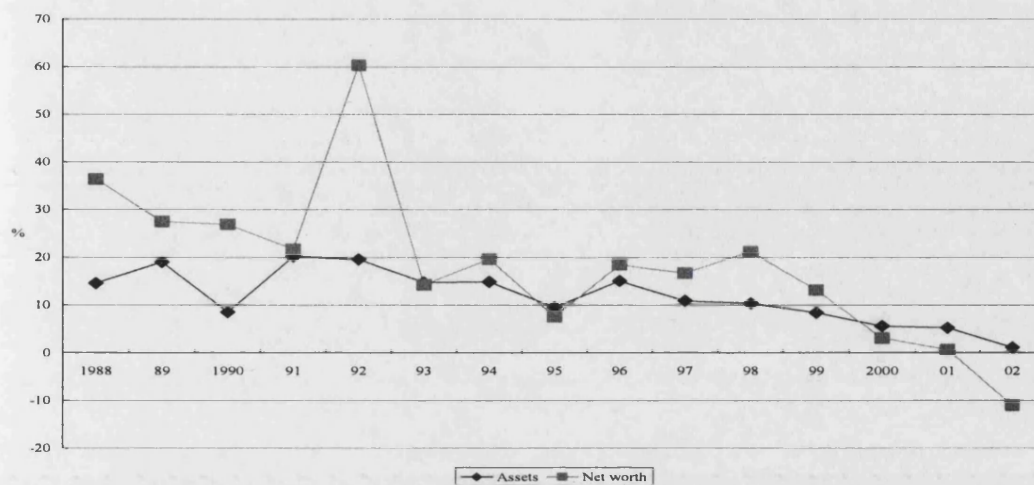
The adoption of the BIS standard in Taiwan led Taiwanese banks to adjust their behaviour. For instance, the annual rate of increase in the assets of Taiwanese banks continued to decline from 1992 onwards (see Figure 7.1). In addition, while the banks' ratio of net worth to total assets ranged only from 2.7 to 3.9 percent between 1984 and 1988, it rose to 5.6 percent in 1992 and continued to increase to 7.0 percent by 1999.⁴¹⁴ However, the costs of Taiwanese banks complying with the BIS standard appeared to be not very high in general, until the late 1990s. As Figure 7.1 shows, the annual increase rate of net worth of the banks surpassed the asset increase rate during most of the 1990s. Although NPLs began to increase from the early 1990s, their size was at a manageable level until the mid-1990s: the official ratio of NPLs to total assets of Taiwanese banks was below 3 percent until 1996.⁴¹⁵ As a result, even though there were a few weakly-capitalised banks, the implementation of the BIS standard was, by and large, smooth until the late 1990s.⁴¹⁶

⁴¹⁴ The ratio began to drop from 2000, reaching 5.8 percent in 2002.

⁴¹⁵ Until July 2005, official NPLs covered the following: loans for which payment of principal was overdue for more than three months; instalment repayments for medium and long-term loans that were overdue for more than six months; and any loan of which repayment of interest was overdue for more than six months.

⁴¹⁶ Author's interview with Wang Jiunn-Chih; author's confidential interview with a senior BoMA official, by email, 2 September 2004.

Figure 7.1 Annual increase rates of assets and net worth of Taiwanese banks, 1988-2002
(end of period; %)

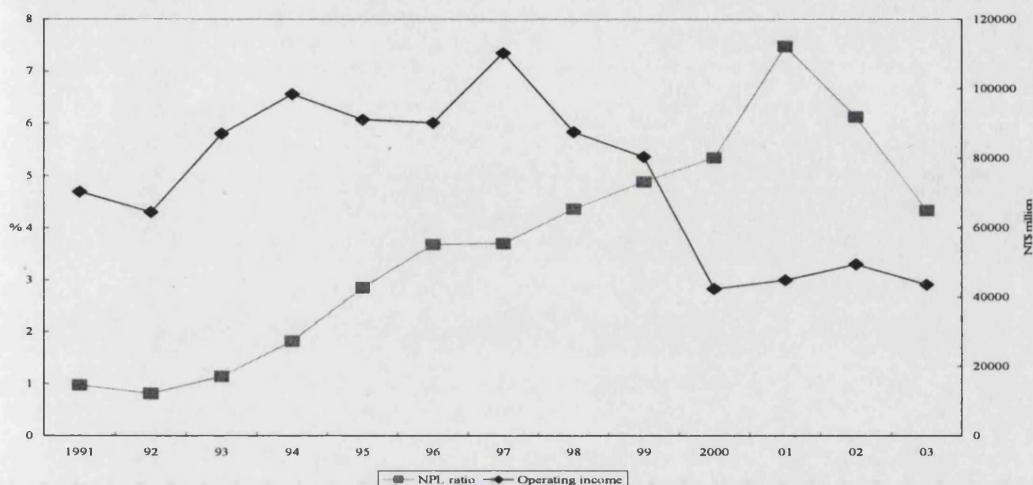


Source: Central Bank of China, *Jinrong Jigou Yewu Gaikuang Nianbao* (Financial Institutions Business Operation Annual Report).

Note: All domestic general banks are included.

However, although Taiwan weathered the 1997 Asian financial crisis largely unscathed, the financial condition of Taiwanese banks began to deteriorate from the late 1990s. A range of factors—the loss of competitiveness of Taiwan’s traditional industries to their mainland rivals from the mid-1990s, a decade long recession in the property market, strong competition in an over-crowded and fragmented financial system, poor lending practices of banks, and so on—caused a sharp increase in NPLs (Fitch Ratings 2002b: 2, 2002c: 2-3; S&P’s 2003: 15). The official volume of NPLs in all domestic banks reached a record high of TWD 1,087 billion at the end of 2001, raising the NPL ratio to 7.5 percent from 3.7 percent at the end of 1997. In the meantime, the operating incomes of the banks drastically declined from 1998. The aggregate volume of operating income in all domestic banks contracted by more than 40 percent from 1998 to 2000 (see Figure 7.2). In early 1999, a senior economist at the central bank came to comment: “A local-made banking crisis has already hit Taiwan” (*China News* 8 February 1999).

Figure 7.2 The financial condition of Taiwanese banks, 1991-2003
(end of period; %; TWD million)



Source: Central Bank of China, *NPL Ratios of Domestic Banks*; Central Bank of China, various issues of *Jinrong Jigou Yewu Gaikuang Nianbao* (Financial Institutions Business Operation Annual Report).
Note: Before 1992, the NPL figures only included the data of domestic banking units of Taiwanese banks. Since 1993, the figures were compiled on a consolidated basis, and included the data of domestic banking units, offshore banking units and overseas branches of Taiwanese banks.

As fears of a banking crisis in the country were growing, the government began to put substantial pressure on banks to improve their asset quality. The MFT required banks to cut their “overdue loan” ratios, which hit 5.1 percent at the end of March 1999, to under 2.5 percent in four years, despite opposition from banks, which argued that their BIS CARs would slide below 8 percent under the plan (*Taiwan Economic News* 13 May 1999).⁴¹⁷ Also, in August 2002, the government introduced a new policy, the “2-5-8 financial target.” Under the policy, banks were required to reduce their NPL ratios to below 5 percent within two years while maintaining their BIS CARs above 8 percent (BoMA 2003a: 31). These policies, which forced banks to reduce impaired assets, placed heavy downward pressure on their BIS CARs.

The disposal of NPLs caused operating losses for banks, leading to erosion of the capital bases of several. According to an estimate by Fitch Ratings (2003a: 2), the “2-5-8 financial target” was expected to reduce the banking sector’s average BIS CAR by roughly 2 percentage points, and about 35 percent of all Taiwanese banks were expected to face difficulty in maintaining their BIS CARs above the required 8 percent minimum. Banks’ disposal of impaired assets began to accelerate from early 2000. Overall, banks

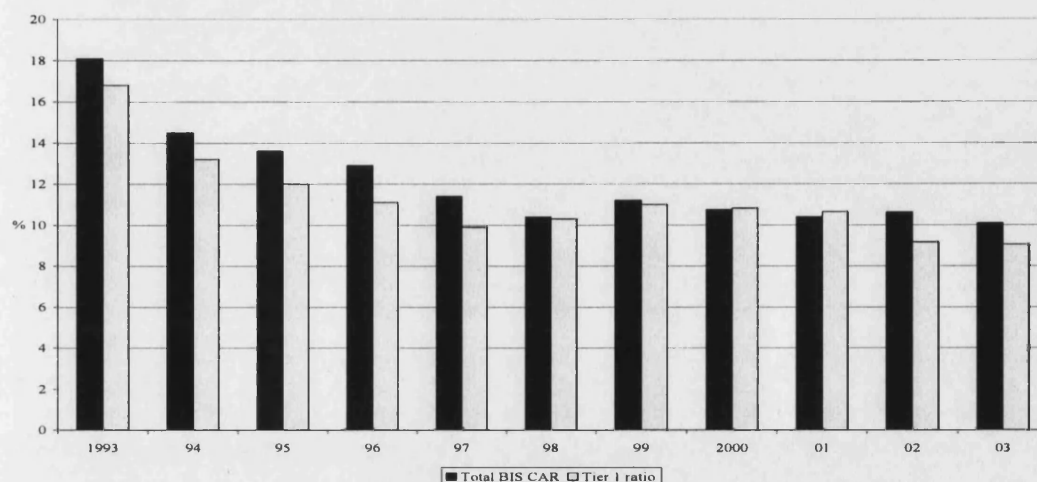
⁴¹⁷ “Overdue loans” were essentially six months in arrears and were reported by banks to the MFT, which allowed several items to be deducted from the NPL calculation. Therefore, the size of “overdue loans” was usually smaller than that of NPLs. The data on “overdue loans” was published until March 2001 (Fitch Ratings 2001: 2).

wrote off over TWD 900 billion in problem assets during 2001 to 2003, equivalent to about 60 percent of the sector's aggregate net worth at the end of 2000 (S&P's CreditWeek 2004). As a result, the sector reported its first pre-tax losses of TWD 47.3 billion (about USD 1.5 billion) in the first half of 2002 (Fitch Ratings 2002d: 3). In short, costs for Taiwanese banks to comply with the BIS standard drastically rose from the late 1990s and remained high through the early 2000s due to their weakening financial condition and pressure from the government on them to accelerate the disposal of NPLs.

7.2 A shift from comprehensive to cosmetic compliance

Despite sharply rising compliance costs from the late 1990s, Taiwanese banks' compliance showed a fair record on formal compliance with the BIS standard throughout the 1990s to the early 2000s. BIS CARs of all domestic banks reached an average of about 20 percent, more than double the required minimum 8 percent, at the end of 1993. Even though the ratio dropped below 12 percent after 1997, it was still over 10 percent at the end of 2003. Moreover, the capital bases of the banks were mostly composed of tier 1 capital, which was a more reliable capital base than tier 2 capital. The average tier 1 ratio was higher than 8 percent, staying at over 9 percent during the period. In fact, the tier 1 ratio surpassed the overall BIS CAR in 2000 and 2001 (see Figure 7.3).

Figure 7.3 The average BIS CAR of Taiwanese banks, 1993-2003
(end of period; %)



Source: Central Bank of China, various issues of *Benguo Yinhang Yingyun Jixiao Jibao* (Conditions and

Performance of Domestic Banks).

The high BIS CARs were not caused by a few banks with extremely high ratios. A large number of banks kept their BIS CARs above 10 percent even after the late 1990s, and more than half the banks had maintained their BIS CARs above 10 percent at the end of 2003. By contrast, a very limited number of banks failed to comply with the 8 percent rule. There were only one or two compliance failures before 1999, with the exception of 1993, on an annual basis. As the financial condition of the banks deteriorated, the number of compliance failures slightly increased from 1999, marking a high of six in 2002 (see Table 7.3). However, the number of banks that failed to clear the minimum 8 percent was still limited to about one tenth of the total banks between 1999 and 2003.

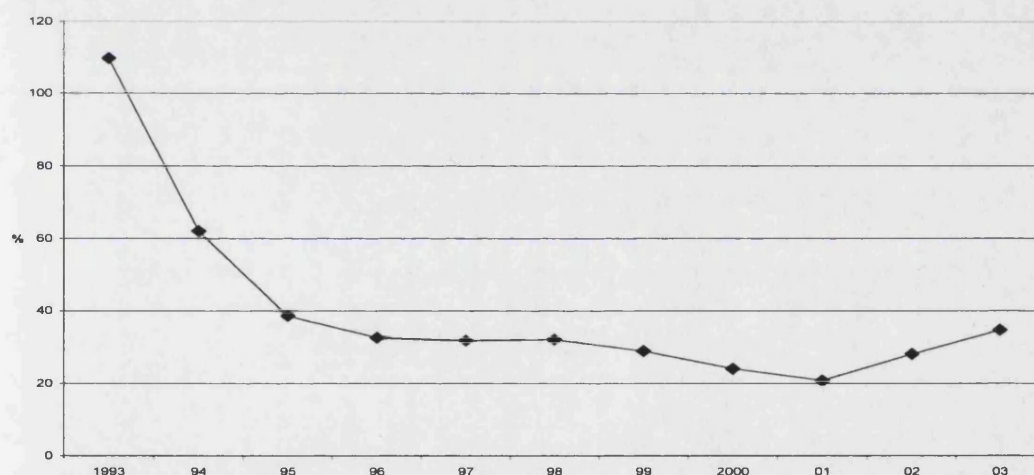
Table 7.3 The distribution of BIS CARs of Taiwanese banks, 1993-2002
(end of period; number)

| | 1993 | 1994 | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 |
|-------------------------------------|------|------|------|------|------|------|------|------|------|------|------|
| 10% and higher | 28 | 35 | 31 | 35 | 37 | 23 | 30 | 29 | 29 | 31 | 28 |
| 8% and higher but lower than 10% | 10 | 6 | 9 | 6 | 9 | 23 | 18 | 19 | 19 | 15 | 17 |
| Lower than 8% | 3 | 1 | 2 | 1 | 1 | 2 | 4 | 5 | 5 | 6 | 5 |
| Total number of banks | 41 | 42 | 42 | 42 | 47 | 48 | 52 | 53 | 53 | 52 | 50 |

Source: Central Bank of China, various issues of *Benguo Yinhang Yingyun Jixiao Jibao* (Conditions and Performance of Domestic Banks).

In addition, during the early 1990s, the disclosed BIS CARs of Taiwanese banks largely reflected their actual capital condition. The ratio of loan loss provisions to official NPLs was about 110 percent in 1993 (see Figure 7.4). In fact, as will be discussed shortly, the official definition of NPLs was not strong, and, therefore, the disclosed BIS CARs should be discounted to some extent in order to fully reflect the actual capital soundness of the banks. However, given that Taiwanese banks carried a very limited amount of impaired assets during the early 1990s, the discount of the significance of the disclosed BIS CARs should be limited.⁴¹⁸ Also, except for the rules on asset classification and provisioning, there was no other significant regulatory forbearance exercised by the Taiwanese regulatory authority in the area of bank capital adequacy during this period. Therefore, Taiwan's compliance with the BIS standard during the early 1990s was by and large comprehensive.

Figure 7.4 Loan loss provisions to NPLs ratio of Taiwanese banks, 1993-2003
(end of period; %)



Source: Central Bank of China, various issues of *Benguo Yinhang Yingyun Jixiao Jibao* (Conditions and Performance of Domestic Banks).

However, the disclosed BIS CARs of Taiwanese banks failed to reflect their actual capital condition from the mid-1990s. From this point on, NPLs in the banks were significantly under-provisioned, which inflated the level of tier 1 capital. As Figure 7.4 shows, the ratio of loan loss provisions to official NPLs sharply dropped from the mid-1990s, when NPLs began to increase sharply. The ratio had since ranged merely from

⁴¹⁸ The official ratio of NPLs to total assets of Taiwanese banks was below 1 percent during 1991 and 1992 and below 2 percent during 1993 and 1994.

20 to 40 percent, hitting a low of 20 percent at the end of 2001.⁴¹⁹ Moreover, the official definition of NPLs was narrow, not including either loans with interest payment overdue for more than three months but less than six months or restructured loans.⁴²⁰ According to an estimate by S&P's and the Taiwan Ratings Corporation, which employed a broader definition of NPLs by adding loans overdue for more than three months, restructured loans and foreclosed assets, NPLs in Taiwanese banks amounted to 13 percent of the total loans at the end of 2002, whereas the official volume of NPLs accounted for only 6.4 percent of them (S&P's 2003: 15). Therefore, if a broader definition of NPL was employed, the loan loss provisions ratio of Taiwanese banks would have been lower. Indeed, Taiwanese banks admitted that a large portion of their performing loans would be categorised as NPLs under stricter regulations of asset classification, such as those employed by foreign countries such as, for example, the United States (see FFH 2003: 39).⁴²¹

In fact, the required level of loan loss provision was low, for example, even in comparison with the Korean rules before the financial crisis. Taiwanese banks were required to classify their loans into four categories: "normal", "special mention", "doubtful", and "loss". No provisions were required for loans categorised not only as "normal" but also as "special mention." Also, only 50 percent of "doubtful" loans were required to be provisioned, although "loss" loans had to be fully provisioned (BoMA 2004: 35). Because provisions for "doubtful" (and "loss") loans were classified as special provisions (FFH 2003: 98), which were not eligible for inclusion in the regulatory capital, the low requirement of provisions for loans in the category could directly inflate the disclosed BIS CARs of banks through a rise in the tier 1 capital.

Accordingly, during the early 2000s, even though Taiwanese banks were in compliance with the required 8 percent, it was widely admitted—even by the banks (see FFH 2003: 38)—that a regulatory requirement of a substantial increase in their loan loss provisions would have driven their BIS CARs under 8 percent (see Fitch Ratings 2002c: 4; S&P's 2003: 38). Indeed, according to an estimate by Fitch Ratings using an official volume of impaired assets, thirteen banks out of thirty two under its coverage in 2001 were technically insolvent—a net NPLs (the sum of official NPLs and "loans under

⁴¹⁹ The ratio of Taiwanese banks was at the lowest level compared with foreign banks. The ratio was 118 percent for U.S. banks, and 86 percent for German banks, 70 percent for U.K. banks in 2001. See IMF (2003a) for more international data.

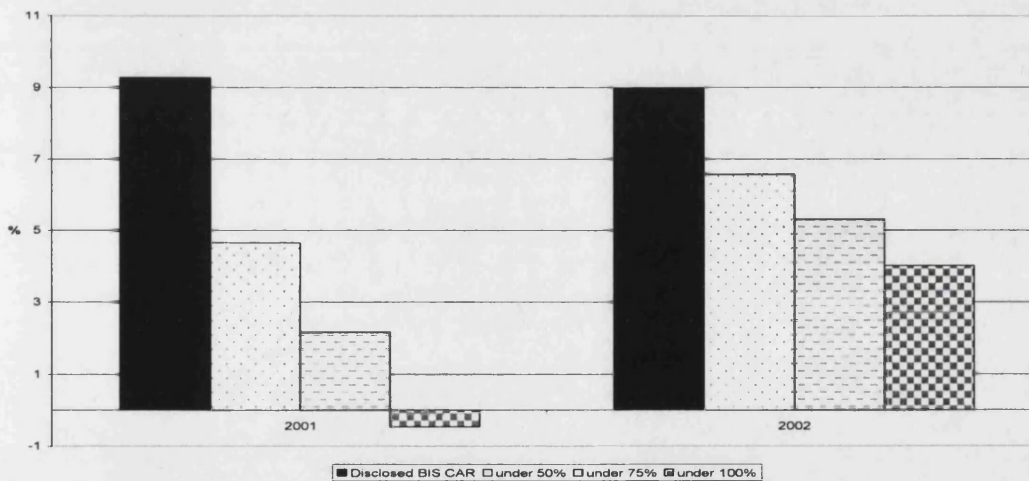
⁴²⁰ See note 415 for the official definition of NPLs until July 2005.

⁴²¹ For example, Boadao Commercial Bank reduced its official volume of NPLs by removing close to TWD 4 billion (3.5 times pre-provision profits) between the end of 2000 and June 2001, largely by rescheduling NPLs (Fitch Ratings 2001: 4).

surveillance”⁴²²) to net worth ratio in excess of 100 percent (Fitch Ratings 2002c: 4). Nevertheless, the disclosed BIS CARs of most banks surpassed 8 percent in the year.

Figure 7.5 provides more information on the actual capital condition of Taiwanese banks during the early 2000s. The BIS CARs of First Commercial Bank, one of the three major commercial banks in Taiwan, at the end of 2001 and 2002 were estimated under the assumption of stricter provisioning requirements. The items of “loans under surveillance”, as well as official NPLs, were included in NPLs. The bank’s BIS CARs were estimated under three different scenarios: write-offs of 50, 75, and 100 percent of the unprovisioned portion of the NPLs.⁴²³ While the bank’s disclosed BIS CAR was 9.3 percent at the end of 2001, the estimated BIS CAR amounted to only half of the disclosed figure under the 50 percent write-offs scenario and it became negative under the 100 percent write-offs scenario. Although the estimated BIS CARs increased at the end of 2002, they were still far below 8 percent in all three scenarios.

Figure 7.5 Adjusted BIS CARs of First Commercial Bank, 2001-2002
(end of period; %)



Source: The author’s own estimation from First Financial Holdings, 2003, *Global Depositary Shares Offering Circular*.

The above analysis of the compliance record of Taiwanese banks concludes that

⁴²² “Loans under surveillance” included the following: term loans overdue for three months but less than six months; loans with principal not yet overdue or overdue for less than three months but with interests payments overdue for more than three months but less than six months; and loans whose overdue period reached the official NPL standard but were exempt from being classified as a NPL (CBC 2003). Generally, the official NPL standard was treated as a narrow definition of NPLs while a broad definition of NPLs aggregated official NPLs and “loans under surveillance”.

⁴²³ When First Commercial Bank sold its NPLs to a foreign asset management company in March 2000, an estimated loss rate of the sale was 75 percent (Fitch Ratings 2002b: 3).

since most Taiwanese banks were in formal compliance with the BIS standard despite their growing compliance costs, it appeared that the banks were under pressure to comply with it. Secondly, in spite of formal compliance, Taiwanese banks' compliance shifted from reasonably comprehensive to cosmetic compliance from the mid-1990s onwards. The following sections address what explains the formal compliance record of Taiwanese banks and what caused the country's failure of comprehensive compliance after the early 1990s.

7.3 The operation of compliance mechanisms

Taiwanese banks' formal compliance with the BIS standard was attributable to compliance pressures of three kinds; from foreign countries, from markets, and from the domestic regulatory authorities. The regulatory enforcement by the domestic regulatory authority appeared to play the most pivotal role in ensuring the compliance, while the effect of pressure from foreign regulatory authorities on the compliance appeared to be most limited. Meanwhile, the cosmetic compliance of Taiwanese banks with the BIS standard after the early 1990s appeared to be partly attributable to the absence of substantial external pressures—both from foreign countries and from markets—on them to improve their capital soundness.

The domestic compliance mechanism

In Taiwan, the domestic compliance mechanism operated throughout the 1990s and the early 2000s, as the Taiwanese regulatory authority had the willingness to maintain the stability of the banking sector by implementing the BIS standard. In contrast to the Japanese or the Korean regulatory authorities during the early 1990s, the Taiwanese regulatory authority intended to punish noncompliant banks. In consequence, the primary pressure on Taiwanese banks to formally comply with the BIS standard came from the domestic regulatory authority through all the period from the 1990s to the early 2000s.⁴²⁴

Penalties that the MFT could impose on banks for noncompliance with the BIS standard were explicitly laid out in the 1989 amendment of the Banking Law. A bank that failed to meet the required 8 percent minimum could be prohibited from

⁴²⁴ Author's confidential interviews with bankers in major Taiwanese banks, Taipei, 27 August 2004 and 1 September 2004.

distributing its earnings. A bank with a CAR beyond 6 but below 8 percent was not allowed to distribute more than 20 percent of its net profits after-tax. A bank with a CAR below 6 percent was entirely prohibited from distributing its earnings. A PCA system was not implemented in Taiwan, and the MFT had discretion in taking regulatory actions. However, the enforcement of the BIS standard by the ministry was by and large faithful. The penalties were, in practice, imposed against banks whose BIS CARs fell below these thresholds.⁴²⁵

Furthermore, the scope of penalties imposed against compliance failure was broader in practice than the provisions prescribed in the law. A bank's compliance failure could invoke limitations on its business activities.⁴²⁶ The MFT prohibited a bank with its BIS CAR below 8 percent from engaging in the unsecured loan business in 1994, even though there was political pressure to protect the bank.⁴²⁷ When the BIS CAR of a bank dropped below 8 percent in 1995, the MFT forced it to either write off some NPLs or set aside sufficient provisions against overdue credit. The ministry required the bank to submit a plan covering capital infusion and improvement within a specified period of time, and also instructed the Central Deposit Insurance Corporation (CDIC) to send staff to be stationed at the bank to supervise and assist conduct of business (BoMA 1996a: 47).

As the financial condition of Taiwanese banks was aggravated, it became a salient task for the regulatory authority to ensure the capital adequacy of the banks.⁴²⁸ As a result, regulatory penalties for noncompliance with the BIS standard were strengthened. The amendment of the Banking Law of November 2000 made a bank with a BIS CAR below the regulatory minimum subject to a fine of between TWD 2 million and TWD 10 million (approximately between USD 60,000 and USD 310,000). When a bank failed to correct its violations within the period specified by the MFT, the ministry could impose additional fines on a daily basis, remove the responsible person of the bank, or revoke its banking license depending on the seriousness of violation.

Changes in the regulations of bank capital adequacy in October 2001 empowered the MFT to impose any of the following sanctions on a bank when its BIS CAR fell

⁴²⁵ Author's interview with Wang Jiunn-Chih; author's confidential interview with a senior BoMA official, by email, 2 September 2004. See also *Taiwan Economic News* (15 December 2000).

⁴²⁶ Author's interview with Wang Jiunn-Chih; author's confidential interview with a senior BoMA official, Taipei, 2 November 2004.

⁴²⁷ Author's interview with Wang Jiunn-Chih.

⁴²⁸ After the 1997 Asian financial crisis, the Taiwan government was carrying out the overall strengthening of the financial system. See Liou (2002: 141-142).

below 6 percent: prohibition of the distribution of any payments to directors; prohibition of equity investments; prohibition of the application for the opening of new branches; limitation on the business that could increase the bank's risky assets; a regulatory order to dispose of equity investments; and a regulatory order to close branches.⁴²⁹ In addition, from 2003, a bank with a BIS CAR below 10 percent was prevented from establishing overseas branches (*Taiwan Economic News* 23 October 2002), and, from the same year, a bank was also required to maintain its BIS CARs above 8 percent in order to set up representative offices in China (BoMA 2003b).

The enforcement of compliance with the BIS standard by the regulatory authority gave a strong incentive for Taiwanese banks to formally comply with the standard. Indeed, during the late 1990s and the 2000s, as the financial condition of the banking sector deteriorated, some banks desperately tried to window-dress their balance sheets by classifying some NPLs as "normal" loans in order to avoid regulatory penalties for failure to comply with the BIS standard.⁴³⁰ Taiwanese banks' formal compliance with the standard was largely attributable to the operation of the domestic compliance mechanism, as the following section demonstrates.

Limited role of external compliance pressure

There were also external pressures from foreign regulatory authorities and from markets on Taiwanese banks to comply with the BIS standard. Because the BIS standard was the domestic capital adequacy regulation for Taiwanese banks, they faced external pressures to comply with the standard formally. In addition, some features of the banks' compliance seemed to reflect the operation of external pressures for comprehensive compliance. Yet, external compliance pressures played a limited role in inducing Taiwanese banks to comply with the BIS standard formally. Also, there was not substantial external pressure on banks to comply with the BIS standard comprehensively.

Regulation by foreign regulatory authorities over banks to comply with their home regulations was likely to force Taiwanese banks operating in these countries to comply with the BIS standard formally. However, the compliance pressure from foreign regulatory authorities did not appear to fully explain the banks' formal compliance

⁴²⁹ The new regulations replaced the Rules Governing the Coverage, Calculation Method of Owned Capital and Risk-Weighted Assets and Limitation to Distribution of Earning for Those without Meeting the Standard.

⁴³⁰ Author's confidential interview with a banker in a major Taiwanese bank, Taipei, 27 August 2004.

record. The number of Taiwanese banks that were exposed to this kind of compliance pressure was not high. As Table 4.2 showed, overseas activities of Taiwanese banks rapidly increased. Nonetheless, only a limited proportion of Taiwanese banks had overseas establishments. Only ten out of a total of thirty-two banks had overseas footholds at the end of 1992. In spite of an increase in the number of banks with overseas establishments, less than half of the total Taiwanese banks had branches or representative offices in foreign countries at the end of 2001. Thus, the pressure from foreign supervisory authorities to comply with the BIS standard could only be brought to bear on a limited number of Taiwanese banks during the 1990s and early 2000s.

There was no substantial pressure from foreign regulatory authorities on Taiwanese banks to comply with the BIS standard comprehensively, despite their weakening actual capital adequacy. In fact, some foreign regulatory authorities carefully observed the BIS CAR calculation process of Taiwanese banks with overseas branches in their countries. Nevertheless, they did not require those banks to improve their capital bases either qualitatively or quantitatively, since they accepted Taiwan's required BIS CAR minimum of 8 percent.⁴³¹ Also, even though some countries set a required minimum BIS CAR higher than 8 percent for domestic banks, Taiwanese banks that did not meet the country's required minimum BIS CARs had no problem in doing business in those countries, as long as they cleared the Taiwan's rule of 8 percent; neither did they feel pressure to increase their BIS CARs from the higher required minimum BIS CARs in the countries.⁴³² The absence of an overt financial crisis in Taiwan may have reduced the willingness of foreign countries to put significant pressure on Taiwanese banks to improve their soundness. In addition, the Taiwanese BIS standard *per se* had no elements which could be regarded as conflicting with the Basel Accord.

As analysed earlier, a bank faces market pressure to clear the required regulatory minimum CAR, and indeed Taiwanese banks believed that their creditworthiness would be tarnished in markets if their disclosed BIS CARs failed to meet the regulatory 8 percent minimum.⁴³³ Thus, market pressure, along with domestic regulatory

⁴³¹ Author's confidential interview with a banker in a major Taiwanese bank, Taipei, 27 August 2004.

⁴³² Author's confidential interviews with a banker in a major Taiwanese bank, Taipei, 27 August 2004, and a senior BoMA official, by email, 2 September 2004. For example, among Asian countries, Hong Kong set up a required BIS CAR minimum at 10 percent, and Singapore at 12 percent for domestic banks, while the BIS CAR of First Commercial Bank, which had branches in these countries, was below 10 percent from 1999 to 2003. However, the bank did not face problems in doing business in the countries.

⁴³³ Author's interview with Wang Jiunn-Chih; author's confidential interview with a banker in a

enforcement, played a role in ensuring Taiwanese banks formally complied with the BIS standard.

Yet Taiwanese banks did not feel strong pressure from markets to comply with the BIS standard comprehensively, or to increase their BIS CARs, as long as they cleared the regulatory 8 percent minimum.⁴³⁴ In fact, BIS CARs of the big three commercial banks were below 10 percent, which was widely cited as a level for competent banks, for much of the time between 1998 and 2003, reaching about 9 percent at the end of 2002. Nonetheless, the relatively low BIS CAR level of the banks did not cause them significant disadvantages in doing business in international financial markets during the period.⁴³⁵ Meanwhile, in Taiwan, “BIS standard” was still only jargon for financial experts, and there was little evidence that general domestic depositors shifted money according to banks’ compliance with the BIS standard.⁴³⁶

One may question why a good number of Taiwanese banks maintained a high level of BIS CARs and a high proportion of tier 1 capital when external pressures for comprehensive compliance were not substantial. In fact, the Taiwanese regulatory authority did not require, either explicitly or implicitly, Taiwanese banks to keep their BIS CARs higher than 8 percent or to maintain high tier 1 ratios, except for the new regulations governing the opening of overseas footholds introduced in 2003.⁴³⁷ On the contrary, the regulatory authority helped the banks increase their capital bases when their financial condition worsened, by allowing them to issue subordinate debt and preferred stocks.⁴³⁸ Yet, consideration of the following factors confirms the weak effectiveness of external pressure for comprehensive compliance.

For government-owned banks with a high BIS CAR, this high CAR resulted from

major Taiwanese bank, Taipei, 27 August 2004.

⁴³⁴ Author’s confidential interview with a banker in a major Taiwanese bank, Taipei, 27 August 2004. This perception appeared stronger among government-owned banks or big banks compared with small private banks (author’s confidential interview with a banker in a major Taiwanese bank, Taipei, 27 August 2004). For an economic analysis to support this argument, see Yu (2000: 113).

⁴³⁵ Author’s confidential interview with a banker of a major Taiwanese bank, Taipei, 27 August 2004.

⁴³⁶ Deposit growth rates of Taiwanese banks that failed to meet the required 8 percent minimum sometimes exceeded the deposit growth rate of the overall bank sector. For example, MaCoto Bank’s (private commercial bank) BIS CAR dropped to 5.7 percent at the end of July 1998 (the ratio recovered to 8.5 percent at the end of year), but its deposits grew by 50 percent during the year, in which the annual deposit growth rate of the banking sector was 10.7 percent. Also, Pan Asia Bank’s (private commercial bank) was below 8 percent between the end of 1998 and the end of 2003, but its annual deposit growth rate surpassed the annual growth rate of the overall banking sector in 1999 and in 2001.

⁴³⁷ Author’s confidential interview with a senior BoMA official, by email, 2 September 2004.

⁴³⁸ Author’s confidential interview with a senior BoMA official, Taipei, 2 November 2004.

their peculiar financial structures, which maintained a large volume of claims on the government and as a result reduced the size of the risk-weighted assets.⁴³⁹ For example, about half of the loans of the Bank of Taiwan, whose BIS CAR reached 14.6 percent (its historical low since 1995) at the end of 2003, consisted of claims on government agencies (42 percent) or government enterprises (3 percent) (Bank of Taiwan 2003).⁴⁴⁰ For private banks, the minimum paid-in capital requirement was extremely high, amounting to TWD 10 billion, while their asset size was relatively small. Indeed, the BIS CARs of most private banks that were established after the 1989 amendment of the Banking Law were extremely high in the early 1990s, reaching 31 percent on average at the end of 1993. Finally, the poor development of local financial markets hindered banks from issuing tier 2 capital instruments;⁴⁴¹ subordinated debt was not introduced in Taiwan until 1998.

7.4 Failure of comprehensive compliance

Taiwanese banks' cosmetic compliance with the BIS standard after the early 1990s resulted from regulatory forbearance by the domestic regulatory authority. The regulatory authority maintained lenient rules on asset classification and provisioning for an extraordinarily long period, lagging behind other Asian countries. Furthermore, as the financial condition of Taiwanese banks deteriorated, the regulatory authority sometimes allowed banks to categorise NPLs as "normal" loans,⁴⁴² and also allowed banks to not report their losses generated from holdings of securities (in 1998) (*China News* 8 February 1999b). In addition, the CBC permitted banks to amortise losses from selling NPLs over a five-year period and not to deduct the unamortised losses from the regulatory capital (Fitch Ratings 2002a: 2). Thus, it was obvious that the regulatory authority intentionally reduced the compliance costs of Taiwanese banks in practice as their financial condition weakened. This section addresses why the regulatory authority, which forced banks to comply with the BIS standard in order to maintain stability in the

⁴³⁹ Author's interview with Wang Jiunn-Chih.

⁴⁴⁰ According to Fitch Ratings (2003b: 4), banks from emerging markets tended to maintain higher tier 1 ratios due to their large holdings of sovereign debt.

⁴⁴¹ Author's interview with Wang Jiunn-Chih; author's confidential interview with a senior BoMA official, by email, 2 September 2004.

⁴⁴² Confidential author interview, banker of a major Taiwanese bank, Taipei, 27 August 2004. For example, the MFT permitted the credit banks of failed conglomerates such as Hong Kyo, Tuntex and Ever Fortune to classify the problem exposures as "normal" loans in late 1998 (Fitch Ratings 2002c: 2-3).

banking sector, opted for cosmetic compliance as the financial condition of the banking sector deteriorated.

Systemic incapacity

The regulatory forbearance appeared to be an inevitable choice of the regulatory authority in order to maintain financial stability, in the absence of an appropriate financial safety net to deal with failed banks. As discussed earlier, the regulatory authority had traditionally put great emphasis on the stability of the financial system.⁴⁴³ Yet, instability in the financial system was growing from the mid-1990s. In 1995, the MFT planned to close a troubled small credit cooperative association in the Changhua region, but all banks in the region faced bank runs the following day, and banks in the regions near to Changhua faced bank runs the day after that; eventually the ministry had to change its policy to request a state-owned bank to rescue the credit union.⁴⁴⁴ Since then, more than twenty bank runs have occurred at commercial banks and small financial institutions through the second half of the 1990s (Kuo 2000: 16). In the late 1990s, fears of a banking crisis emerged, as mentioned earlier. Indeed, Taiwanese banks' credit ratings were downgraded during the late 1990s and the early 2000s.⁴⁴⁵

In this situation, the stricter implementation of the BIS standard could have aggravated instability in the financial system in the short-term. The implementation of stricter accounting rules would have caused the capital bases of Taiwanese banks to contract, driving a large part of them to fail to meet the required 8 percent minimum or even to go bankrupt. To prevent financial instability in this situation, an appropriate financial safety net to deal with ailing banks should have been in place. Yet, there was no such financial safety net in the country. Therefore, there was the likelihood that the implementation of stricter accounting rules could trigger the outbreak of a financial crisis. Accordingly, the regulatory authority had to keep lenient accounting rules, helping banks maintain their disclosed BIS CARs over 8 percent.

The lack of an appropriate financial safety net was partly the result of financial

⁴⁴³ See Chapter 3 (section 3.3).

⁴⁴⁴ Author's interview with Wang Jiunn-Chih.

⁴⁴⁵ For example, S&P's Long-Term Issuer Ratings were downgraded for the Bank of Taiwan from AA- (since October 1995) to A+ in July 1997, for Taiwan Cooperative Bank from A (since February 1997) to BBB in May 1999, for China Development Industrial Bank from A (since August 1998) to A- in May 2002, for International Commercial Bank of China from A+ (since January 1998) to A in October 2002, and for Grand Commercial Bank from BB+ (since August 1998) to BB in November 2002.

liberalisation, which was accelerated by the 1989 amendment of the Banking Law. Before the 1990s, when most banks were government-owned, the likelihood of a banking crisis may have not been high as the government could support the banks directly. However, the 1989 amendment allowed the establishment of a large number of new private banks. As a result, the number of private commercial banks increased from three in 1990 to twenty-two by 2000. The government traditionally forced healthy government-owned banks to take over troubled small financial institutions. However, the number of government-owned banks declined due to privatisation in the banking sector; nine government-owned banks were privatised by 2001, reducing the number of banks fully owned by the government to only five (BoMA 2002: 31). In addition, as the financial condition of the overall banking sector had been aggravated, it became difficult to find banks strong enough to take over weak banks.⁴⁴⁶ In March 2002, Finance Minister Lee Yung-San commented that the government would have to let banks go bankrupt, but under the condition that it would not trigger instability in the banking system, indicating: “[t]here are not enough big banks to absorb bad banks” (*Euromoney* April 2002).

There was a deposit insurance system in the country, and, in fact, until 2001, the only official resource that the government could resort to in dealing with banking problems were the deposit insurance funds in CDIC (Fitch Ratings 2002d: 3). However, CDIC was so under-funded that its capacity to deal with troubled financial institutions was highly limited; the total insurance funds available amounted to only TWD 13 billion in 2001. Given that the minimum paid-in capital requirement for commercial banks was TWD 10 billion, the insolvency of one bank could wipe out the funds in the CDIC and make it bankrupt (Yin 2001: 26).

The government strengthened the financial safety net to an extent by establishing public funds, the Financial Restructuring Fund (FRF), in July 2001.⁴⁴⁷ The FRF aimed to smooth the market exit of troubled financial institutions and thereby avoid triggering a financial crisis (CDIC 2004b). In addition, a temporary blanket insurance system was implemented during the operation of the FRF to maintain financial stability (CDIC 2004a). However, the volume of the FRF was limited to TWD 140 billion, merely accounting for 1.4 percent of the nation’s GDP,⁴⁴⁸ while, according to an estimate by

⁴⁴⁶ Author’s confidential interview with a senior BoMA official, Taipei, 2 November 2004. See also Fitch Ratings (2002c: 4).

⁴⁴⁷ Author’s confidential interview with a senior BoMA official, Taipei, 2 November 2004. See also *Financial Times* (16 May 2002), and Fitch Ratings (2002d: 3).

⁴⁴⁸ The figure was much lower than Japan’s 12 percent and Korea’s 18 percent (*Taiwan News* 22

the government in 2001, the total costs to recapitalise technically insolvent banks were expected to reach TWD 600 billion, 6 percent of the GDP (Fitch Ratings 2002c: 4). Moreover, the primary purpose of the FRF was to deal with community financial institutions, whose distressed financial condition was deemed an immediate threat to the financial system.⁴⁴⁹ Indeed, most of the funds were used in handling such institutions. As a result, although problems in the banking sector had not been properly tackled, only TWD 40 billion remained in the FRF by August 2002 (*Taiwan News* 24 August 2002).

Political sources of the systemic incapacity

The underdevelopment of the financial safety net in Taiwan was essentially generated by political factors, rather than the lack of necessary financial resources *per se*. The Taiwanese government had large financial resources that could be used, in principle, to bail out weak banks. However, institutional arrangements to implement such policies had been underdeveloped for political reasons. Indeed, even during the early 2000s, when the financial condition of the overall Taiwanese banking sector deteriorated, market participants believed that the Taiwanese government could recapitalise ailing banks, if there was no political problem. For instance, a Fitch Ratings (2002c: 4) report on Taiwanese banks in June 2002 commented:

It appears that Taiwan's sovereign financial position (sovereign rating of A+) should be able to afford this recapitalisation [of technically insolvent banks] but the current political deadlock would be the first hurdle to overcome if the government is determined to solve this problem.

The small size of deposit insurance funds was a result of the voluntary participation deposit insurance scheme, which was adopted due to opposition to a mandatory system. When the government introduced a deposit insurance system in 1985, large government-owned banks and local governments that exercised voting control at many of these banks were opposed to a mandatory deposit insurance scheme, arguing that banks' costs for participating in deposit insurance were not justified.⁴⁵⁰ Only three out of eleven major government-owned banks participated in the deposit insurance system

August 2002).

⁴⁴⁹ Author's interview with Chen Zhan-Shen; author's confidential interview with a BoMA official, Taipei, 5 November 2004. See also (*The Banker* July 2001).

⁴⁵⁰ Author's interview with Chen Zhan-Shen.

(as of March 1990). In addition, most of small financial institutions did not join the system (Yang 1994: 315). As a consequence, the size of deposit insurance funds was very limited. In fact, several financial incidents during the mid-1990s led the MFT to amend the deposit insurance system in order to increase the size of the deposit insurance funds, and, as a result, a mandatory deposit insurance system was adopted in 1999 (BoMA 1998, 1999, 2002).⁴⁵¹ However, as discussed earlier, the size of the funds could not grow substantially by the early 2000s.

Also, the government's plans to strengthen the financial safety net and the financial health of the banking sector during the early 2000s failed because of domestic political struggles, which had little to do with banking regulation *per se*. The regulatory authority and the Democratic Progressive Party (DPP) administration, which came to power in 2000, had a strong sincere intention to enhance the soundness of the banking sector. As a result, the government established a plan to build an exit mechanism for distressed banks in order to restructure the banking sector. However, these government policies were blocked by opposition parties in the Legislative Yuan (the legislature), as conflicts between the government and the opposition bloc increased.

Along with the announcement of the "2-5-8 financial target," the government set up a plan to expand the size and functions of the FRF in order to achieve the proposed targets (BoMA 2003a: forewords). The proposal aimed to raise the volume of the FRF to a total of TWD 1.05 trillion. The enlarged FRF was to purchase impaired assets from banks, and banks with negative net worth were to be forced to exit the market once the FRF had made up their negative net worth. Banks with positive net worth would remain in the market but if they lacked internal resources to raise further capital, the FRF was to contribute capital by way of preferred shares up to the required BIS CAR level of 8 percent minimum. Also, the FRF was to increase banks' loan loss provision coverage rates to 30 percent of remaining NPLs from the then average of 20 percent. Ultimately, the MFT aimed to reduce the number of banks from more than fifty at that time to fifteen in two years' time by both phasing out poor quality banks and fostering mergers and acquisitions (Fitch Ratings 2002d: 1-2; *Taiwan Economic News* 22 August 2002; *Taiwan News* 10 October 2002).

Yet, the conflict between the ruling DPP and the KMT-led Opposition over the objectives and the size of the amended FRF blocked its passage in the Legislative Yuan,

⁴⁵¹ Author's interview with Chen Zhan-Shen.

which was dominated by the Opposition.⁴⁵² The Opposition primarily rejected the plan to recapitalise banks that had not yet suffered an open crisis, in order to increase their BIS CARs and to reduce their NPL ratios by injecting public funds. After the failure to secure the passage of the proposal, the minority government amended the initial plan, accepting most demands of the Opposition.⁴⁵³ The proposed enlargement of the FRF was reduced from the initial TWD 910 billion to TWD 540 billion, just for handling two banks already taken over by the government, which then abandoned the plan to recapitalise the banking sector (see Fitch Ratings 2002c: 4;2003c: 3; *FT Investor* 3 June 2003; *The Banker* July 2003).⁴⁵⁴ Nevertheless, the issue of protection of non-deposit general creditors remained a disagreement between the DPP and the Opposition and even within the Opposition bloc, between the KMT and the People's First Party.⁴⁵⁵ As a result, the revised proposal failed to pass in the Legislative Yuan.⁴⁵⁶

Some local and foreign media (*Euromoney* April 2002; *Central News Agency* 6 October 2002) presented a view that the KMT-led Opposition turned down the proposal in order to protect banks. Indeed, banks were traditionally big contributors to the KMT, and financially distressed banks were fiercely opposed to the proposal as they feared government intervention in their management.⁴⁵⁷ However, it should be emphasised that the KMT-led Opposition agreed to the establishment of the FRF in 2001, which closed down more than forty local financial institutions. The cosy relationship between the KMT and such financial institutions had been well-known (see Ho and Lee 2001; Kuo 2000: 19-20). In fact, regarding the proposal to amend the FRF, the Opposition did agree on the plan to close banks with negative net worth. The ties between the KMT and banks under the former KMT government began to be broken by the change of government.⁴⁵⁸ In other words, the main reason why the KMT-led Opposition was

⁴⁵² In the meantime, the government was under heavy criticism from opposition parties to reduce the budget deficit (author's interview with Lee Jih-Chu [Vice-Convener, Finance & Monetary Division of National Policy Foundation (KMT's think tank)], Taipei, 16 November 2004).

⁴⁵³ Author's confidential interview with a BoMA official, Taipei, 5 November 2004.

⁴⁵⁴ The finance minister admitted that the "2-5-8 financial target" was no longer viable under the revised proposal (*FT Investor* 3 June 2003).

⁴⁵⁵ Author's interview with Lee Jih-Chu.

⁴⁵⁶ As of November 2004, the government was planning to raise deposit insurance funds as an alternative scheme to increase funds, to deal with troubled financial institutions. Yet, the plan also had to be passed in the Legislative Yuan.

⁴⁵⁷ Author's interview with Chen Zhan-Sheng.

⁴⁵⁸ Author's interview with Lee Jih-Chu. For example, right after the change of government, banks required KMT-owned firms to refurbish their collateral. The banks' requirement caused the KMT to close unprofitable firms and withdraw about USD 30 billion from stock companies in order to restructure its fragile financial assets (Kuo 2000: 33).

opposed to the financial reform, which would enhance the country's comprehensive compliance with the BIS standard, was not to protect its major potential victims, that is, banks.

The politics of credit claim provides a more plausible explanation of the failure of the proposal. As the 2004 presidential election was approaching, the conflict between the DPP and the Opposition became intense. The DPP government had promoted a series of financial reforms, and financial reform was a key point that the ruling party could focus on for the election (*Taiwan Economic News* 28 April 2003; *Taiwan News* 18 March 2004).⁴⁵⁹ However, the Opposition recognised this, and did not want to allow the DPP to get its way (*Taiwan Economic News* 28 April 2003). It was widely suspected that the Opposition boycotted the proposal in an attempt to undermine the DPP's progress on financial reform ahead of the presidential election (*Associated Press Worldstream* 20 December 2002; *World Markets Analysis* 4 June 2003). It was also widely expected that the proposal would be passed if the Opposition won the election.⁴⁶⁰ However, they lost, and the political deadlock on the proposal was not resolved.

In addition, it is worth noting that there was not a strong demand from voters to increase financial stability immediately. Taiwan did not have the dreadful experience of an open financial crisis, weathering the 1997 Asian financial crisis. As a result, the public sentiment was generally negative towards the idea of injecting tax-payers' money into troubled banks.⁴⁶¹ Accordingly, the Opposition was able to delay the passage of the proposed amendment of the FRF. Also, the assessment of financial policy makers inside the opposition parties on the soundness of the banking sector system was relatively positive; they shared a view that that the sector was not in crisis and that it was not necessary to take drastic steps to improve its soundness.⁴⁶²

It should be pointed out that the DPP government did set forward a plan that would help enhance comprehensive compliance with the BIS standard. In 2003, the MFT established a plan to substitute the four-category loan classification with five categories and increase the level of loan loss provisioning. Loans in arrears by three months or more were to be classified as official NPLs (BoMA 2004: 7, 35). The new rules were to be introduced in July 2005, in which the operation of the FRF was to cease. However,

⁴⁵⁹ On the financial reform under the DPP government, see Leou (2005).

⁴⁶⁰ Author's confidential interview with a BoMA official, Taipei, 5 November 2004.

⁴⁶¹ Author's interview with Lee Jih-Chu; author's confidential interview with a BoMA official, Taipei, 5 November 2004.

⁴⁶² Author's interview with Lee Jih-Chu.

the failure to enlarge the FRF made it unclear whether the rules could be faithfully implemented as scheduled. Indeed, after the failure, the Director General of the BoMA took a relaxed stance on the reform, by stating that the government had never said when it would implement the new accounting rules, but rather that the July 2005 date was merely *a target* (*Finance Asia* February 2004).⁴⁶³

After all, the country's failure to comprehensively comply with the BIS standard from the mid-1990s was mainly attributable to the incapacity to deal with banks' failure to comply with the BIS standard formally. Indeed, a PCA system was not implemented for the same reason, even though the regulatory authority was keen to introduce it.⁴⁶⁴ This capacity problem did not result from the lack of necessary financial resources *per se*, as is shown in the fact that the government established a plan to inject a huge amount of public funds into the banking sector. However, political factors hindered the development of institutional arrangements to enable the orderly use of financial resources. Taiwan's capacity problem in complying with the BIS standard was essentially political.

Other factors that hindered comprehensive compliance

Under such a risk of systemic financial crisis, financial regulatory authorities in most countries would have to reduce costs of banks to comply with the capital adequacy rules in order to prevent a crisis of confidence. Therefore, it may be plausible to argue that the absence of an appropriate financial safety net was the major factor that hindered comprehensive compliance with the BIS standard in Taiwan. Nonetheless, it is worth addressing whether there were additional factors to hinder the country's comprehensive compliance with the BIS standard.

There was a decline in bank loans to firms, especially in 1996 and between 2001 and 2002, during which the annual rate of loan increase to firms was negative. However, the decrease in bank loans did not result from Taiwanese banks' efforts to comply with the BIS standard.⁴⁶⁵ Disclosed BIS CARs of a majority of Taiwanese banks were safely

⁴⁶³ The Financial Supervisory Commission, the new financial regulatory authority (established in July 2004), strengthened asset classification rules in July 2005. The financial condition of Taiwanese banks improved from 2003, as the national economy recovered; their average NPL ratio fell from 6.1 percent at the end of 2002 to 2.7 percent at the end of 2004. Therefore, the likelihood that the strengthening of the rules would cause financial instability was reduced during the mid-2000s.

⁴⁶⁴ Author's confidential interview with a BoMA official, Taipei, 5 November 2004.

⁴⁶⁵ SMEs were important political partners of the KMT in elections (Cheng 1993: 78).

higher than the regulatory 8 percent minimum through the 1990s and early 2000s, despite their weak actual capital condition. Accordingly, there were few reasons for banks to reduce loans in order to clear the BIS CAR of 8 percent. In other words, the costs of compliance with the BIS standard were not diffused from banks to the other sectors of the economy, due to the relatively high level of banks' BIS CARs.

The decline in bank loans mainly resulted from weak demand for bank loans due to an economic downturn, a decrease in the number of healthy firms or an increase in direct financing through capital markets.⁴⁶⁶ In other words, there was no credit squeeze generated by banks.⁴⁶⁷ In fact, when the MFT established the plan to strengthen the rules on asset classification and provisioning in the early 2000s, it carried out research on its impact on the credit supply in the economy; the conclusion was that the impact would be marginal.⁴⁶⁸ Accordingly, there was no demand from the corporate sector to relax the Taiwanese BIS standard throughout the 1990s and early 2000s. Moreover, the BIS standard was never an important political issue in Taiwan throughout the period.

Yet, there were some factors that may have resulted in inducing cosmetic compliance with the BIS standard: cosy relations between politicians and business, and a decline in policy autonomy of the MFT from political intervention. Since the mid-1980s, Taiwanese conglomerates had grown rapidly due to the liberalisation of financial regulations and domestic markets in the country. These conglomerates developed close relationships with the ruling KMT by providing a massive amount of funds to the party, whose campaign expenses skyrocketed due to political democratisation from the late 1980s (Kuo 2000: 12-13; Kuo and Tsai 1998: 171, 175-176).⁴⁶⁹ Also, conglomerate members' direct participation in politics increased in the early 1990s (Kuo and Tsai 1998: 176). As a result, conglomerates' influences in the legislature were augmented.

When the banking sector was liberalised, licenses for most new private banks were given to those conglomerates, partly due to their close relationship to politicians. As a result, the banks adopted very lenient loan policies to subsidiaries of the conglomerates and also informally to political figures related to them (Kuo 2000: 19). In the meantime, legislators could pressure government-owned banks to give unqualified loans to

⁴⁶⁶ See annual reports of the CBC. Taiwan's economic growth rate gradually declined during the 1990s to the early 2000s; it dropped from 7.6 percent in 1991 to 3.3 percent in 2003, recording a low of -2.2 percent in 2001.

⁴⁶⁷ Also, note that, as Table 6.3 showed, Taiwan's corporations appeared to maintain a relatively sound financing structure in comparison with their Japanese or Korean counterparts.

⁴⁶⁸ Author's confidential interview with a BoMA official, Taipei, 5 November 2004.

⁴⁶⁹ The cosy relations between the KMT and business were well known in the country as "black gold" politics.

business associates or their friends by using the Legislative Yuan's right to review the budgets of government-owned corporations (*The Banker* July 2000). Yet, conglomerates had little incentive to improve their productivity as they operated in protected sectors (Kuo and Tsai 1998: 177). As a result, most of those loans later became non-performing (Kuo 2000: 19). In the circumstances, the borrowers of loans and the banks that wanted to protect them had strong interests in maintaining lenient rules on asset classification and delaying the disposal of NPLs, which otherwise would drive the borrowers into financial difficulty.

The interests of conglomerates and banks could be protected by their close relations with politicians. In the 1992 election, twenty-seven legislators with formal relationships with banks or credit unions were elected. Fifteen legislators elected in the 1995 vote were directors or supervisors of financial institutions. In the 1998 vote, twenty-one legislators with banking interests were elected. Most of these legislators joined the legislature's Finance Committee, which had authority over banking policies, and frequently made proposals to protect the interests of banks and conglomerates (Kuo 2000: 21-22).⁴⁷⁰

The MFT was not an independent regulatory authority in nature. Nevertheless, during the martial law period (1949 to 1987), bureaucracy prevailed over the Legislative Yuan, in the economic policymaking process due to the coherence of the state under a strong presidency (Kuo 2000: 12; Kuo and Tsai 1998: 168).⁴⁷¹ Influence from the independent CBC over the ministry was also likely to enhance the policy autonomy of the MFT from political intervention during the period.⁴⁷² However, as martial law was abolished in 1987, legislators began to assert their legislative power over the financial administration, making the ministry vulnerable to political influence (Kuo 2000: 20). In the meantime, the influence of the CBC over financial regulation weakened over the 1990s.⁴⁷³ As a result, from the late 1980s, the influence of legislators on banking

⁴⁷⁰ For example, during the evaluation process to license new private banks in the late 1980s, legislators who were shareholders of ten different banks supported these banks, and they in return purchased the unlisted stocks of the banks at about USD 3 a share; after the banks were established and listed their stocks, their stock prices immediately more than doubled (Kuo 2000: 21-22).

⁴⁷¹ The Legislative Yuan usually rubber-stamped bills to revise the Banking Law submitted by the MFT during the period (Kuo 2000: 20).

⁴⁷² See Chapter 3 (section 3.3).

⁴⁷³ The CBC was excluded from the process of licensing new private banks; the MFT orchestrated the entire process (Kuo 2000: 20-21). Although the MFT had the obligation to consult with the CBC in establishing capital adequacy regulations prior to the adoption of the BIS standard, the obligation of the ministry was abolished when it constructed the Taiwanese BIS standard of 1992. In April 1997, the status of the CBC was downgraded as an equal, if not

regulation rapidly increased. In the 1989 revision of the Banking Law, legislators revised sixteen out of a total of twenty five articles proposed by the administration. Moreover, in the 1995 revision of the Banking Law, the Legislative Yuan itself proposed and passed two important items, against the preferences of the MFT (Kuo 2000: 21).

Therefore, there was a likelihood that the cosy relations between politicians and business may have hindered the MFT in dealing with NPL problems, which resulted in the failure to comply with the BIS standard comprehensively during the second half of the 1990s. However, it should be noted that the impact of the relations between business and politicians was likely to be substantially lower after the change of government in 2000. The DPP was the main attacker of the cosy relations between politics and business, and, indeed, as mentioned earlier, the DPP government put enormous emphasis on financial reform. In addition, as discussed earlier, the traditional close relations between the KMT and business began to unravel after the government change. The cosy relations between the KMT and business may have been an additional factor that helped cosmetic compliance with the BIS standard indirectly during the second half of the 1990s, but its impact on compliance with the BIS standard became marginal during the early 2000s.

Conclusions

Taiwan's regulatory authority's intention of strengthening the soundness of the banking sector by adopting the BIS standard was reflected in the Taiwanese BIS standard and its enforcement. Compliance enforcement by the regulatory authority, along with the operation of the external compliance mechanisms, induced Taiwanese banks to formally comply with the BIS standard throughout the 1990s and the early 2000s. In addition, the banks' compliance was by and large comprehensive during the early 1990s despite the fact that there was not strong external pressure on them to comply with the BIS standard comprehensively. Moreover, as Taiwanese banks' compliance with the BIS standard became cosmetic from the mid-1990s, the regulatory authority intended to improve the country's compliance with the BIS standard by strengthening the financial safety net to deal with ailing banks and relevant regulations. Yet, the development of the financial safety net, which was necessary for strict implementation of the BIS standard, was hindered by political obstacles. As a result, the country's cosmetic compliance

lower, partner of the MFT (Kuo 2000: 21).

continued throughout the early 2000s. In addition, the growing political influence over banking policies was likely to have contributed to the country's failure to comply with the BIS standard comprehensively during the second half of the 1990s. However, the effect of this factor became trivial during the early 2000s.

CHAPTER 8

Conclusions

The question of what determines compliance with international regulatory regimes has been a central theme of much recent IPE scholarship. Scholars have proposed three competing perspectives on this issue. Systemic theorists focus on compliance pressures on states from other states that will suffer from negative externalities of others' noncompliance. Market-based theorists emphasise that market forces can enhance compliance, often using the BIS standard as a prime example. The domestic perspective argues that the existence of domestic groups whose preferences are in accordance with the regime of concern is critical for compliance. While these perspectives are in theoretical competition, the compliance mechanisms proposed by them are in practice complementary. All or some of these compliance mechanisms may operate simultaneously within an international regulatory regime.

This study has attempted to improve the understanding of the effectiveness of these compliance mechanisms by presenting an in-depth study of compliance with the BIS standard in Japan, Korea, and Taiwan from the late 1980s to the early 2000s. The focus of this study has been on compliance that contributes to the effectiveness of the regulatory regime. In analysing the relationship between regime compliance and regime effectiveness, I have introduced the concepts of cosmetic compliance and comprehensive compliance. Then, I built hypotheses about the operation and the effect of each of the compliance mechanisms, and tested them. This final chapter will integrate the main observations and findings of this study, and will then discuss this study's contributions to the literature on compliance and to broader IPE scholarship.

8.1 Major findings

What determined compliance with the BIS standard in the case countries? What caused the differences in the levels of compliance in these countries? These questions are answered first by revisiting the hypothesis constructed in Chapter 2 and secondly by making a comparative analysis of compliance with the BIS standard in the three case countries.

Three compliance mechanisms

I formulated three main hypotheses in regard to the operation of each of the three compliance mechanisms. The first hypothesis regarding the externality-based compliance mechanism was as follows:

Hypothesis 1: *the externality-based compliance mechanism is more likely to operate towards a country whose noncompliance generates high negative externality to other countries.*

There has been an analytic problem in testing this hypothesis for compliance with the BIS standard because banks were required by foreign countries to comply with their home country capital adequacy regulations in order to do business in those countries, regardless of the type of the regulations. Yet, the analysis of the adoption of the BIS standard in the case countries has clearly demonstrated that this hypothesis is true. Japanese banks' engagement in international banking was substantial during the late 1980s, and, as a result, Japan faced strong direct foreign pressure to agree to establish the BIS standard. In contrast, the international business of banks from non-Basel Committee was trivial. In consequence, G10 countries did not put explicit direct pressure on these countries, including Korea and Taiwan, to adopt the BIS standard, and only mildly encouraged them to do so. It was not until the 1997 financial crisis that foreign countries (through the IMF) put strong pressure on Korea to strengthen its bank capital adequacy regulations to be in line with the Basel Accord.

An additional significant finding is that the regulatory authorities and banks in *all* three countries strongly *believed* that banks' noncompliance with the BIS standard would be punished by foreign regulatory authorities. The belief appeared to be based on the perception that regulatory authorities had an effective means of enforcing foreign banks to comply with the BIS standard by closing their markets to the banks. Most major Japanese banks maintained overseas establishments, although Japanese banks' overall overseas presence declined sharply during the second half of the 1990s. Also, the overseas presence of Korean and Taiwanese banks increased sharply during the 1990s partially due to government encouragement. As a result, a large number of Japanese, Korean, and Taiwanese banks were vulnerable to penalties for noncompliance with the BIS standard by foreign countries in which they did business. Therefore, the regulatory authorities perceived that they had to maintain the BIS standard in order to

protect the banks' overseas business, and banks believed that they had to comply with the BIS standard for the same reason. Importantly, this perception was strengthened due to the general recognition that the BIS standard was *the* best practice among existing bank capital adequacy regulations. This perception of regulatory authorities and banks was an important factor in explaining formal compliance with the BIS standard in the three countries. This finding supports the second hypothesis of the externality-based compliance mechanism:

Hypothesis 2: the externality-based compliance mechanism is more likely to be effective for a country susceptible to the noncompliance response system other countries can employ.

In addition, as the hypothesis anticipated, the externality-based compliance mechanism was not effective in inducing compliance with the BIS standard by banks that were not exposed to the major noncompliance response system of the BIS-standard regime. The Japanese practice of the dual system of capital adequacy regulations was clear evidence to support the hypothesis; the Japanese authorities applied the BIS standard only to banks with overseas establishments, while adopting a different capital adequacy framework for domestic banks with no overseas presence. Even if the BIS standard was applied to both international and domestic banks in Korea and Taiwan, the unitary application of the BIS standard does not reject the hypothesis; the unitary application resulted from the regulatory authorities' expectation of the increasing internationalisation of banks, their concerns about competitive inequality in domestic markets, or their intention to strengthen the soundness of the domestic banking sector.

The final hypothesis about the externality-based compliance mechanism was the following:

Hypothesis 3: the operation of the externality-based compliance mechanism is likely to induce only formal compliance, unless enforcement costs are low.

This hypothesis has been supported by the finding that no significant foreign pressure existed to comprehensively comply with the BIS standard in any of the case countries (except for Korea under the IMF programme), and indeed these countries did not make efforts to achieve comprehensive compliance in anticipation of foreign pressure. As clearly shown in the case of Japan, whose cosmetic compliance with the BIS standard

was well known, the absence of such foreign pressure was not always due to foreign countries' failure to recognise problems in the countries' implementation of the BIS standard. Rather, the critical factor in hindering the operation of the externality-based compliance mechanism for comprehensive compliance with the BIS standard was the high costs in exercising such compliance pressure; while there were few grounds to justify such extensive compliance pressure, the Basel Accord was allowed to be implemented according to national regulatory arrangements. Notably, even in Korea under the IMF programme, the IMF could not effectively force the country to fully implement its policy recommendations to strengthen the country's capital adequacy regulations because of domestic opposition in the country.

As regards market compliance pressure, the first hypothesis was built as follows:

Hypothesis 4: the market compliance mechanism will promote full regime compliance only when market participants accept both its generic principles and its detailed rules.

There was no independent operation of the market compliance mechanism for the BIS standard. There seemed to be an agreement from markets on the need for regulation of banks' capital adequacy. Nevertheless, market participants heavily criticised the BIS standard as crude and arbitrary, and, accordingly, they did not accept the BIS standard as a reliable solvency regulation. Instead, market participants paid attention to economic capital ratios of banks in assessing their capital soundness, and a "desirable" economic capital ratio varied according to banks. As a result, markets did not penalise banks for not adopting the BIS standard, nor was there a positive association between BIS CARs of banks and markets' assessments of banks' soundness. In fact, there was limited pressure from markets on banks to improve their actual capital adequacy. However, the pressure was not directly related with the BIS standard *per se*, nor was the pressure consistent.

There was also evidence to support the second hypothesis concerning market compliance pressure:

Hypothesis 5: compliance pressures may come from markets as a reflection of domestic enforcement, but will not induce compliance above and beyond that required by regulatory authorities.

The findings relating to how market participants viewed banks' noncompliance with the capital regulations governing them have supported this hypothesis. Even though market participants did not credit the BIS standard with a reliable solvency regulation, they did take into account banks' formal compliance in assessing their creditworthiness. As expected, market pressure on banks to formally comply with the BIS standard was a reflection of domestic regulations. Market participants anticipated that banks that failed to comply would face action by the regulatory authorities, and the regulatory penalties could have negative consequences for the stakeholders of the banks, such as investors or creditors. In addition, market participants understood that banks that did not meet such an important requirement might have serious problems. As a result, market pressures did play a role in inducing banks to formally comply with the BIS standard. However, it should be reiterated that such pressures from markets on banks were not necessarily related to compliance with the BIS standard *per se* but to compliance with the relevant domestic regulations.

The last hypothesis regarding market compliance pressures was the following:

Hypothesis 6: market compliance pressures (of both types) are more likely to be effective for a country in which regulatory targets are vulnerable to market forces.

There was a common perception of market compliance pressures for the BIS standard in all three countries, although there was a difference in banks' sensitivity to market forces in the countries. The concern of banks' competitiveness in markets was a key factor that led the Korean regulatory authority to adopt the BIS standard and to cosmetically implement the BIS standard during the early and mid-1990s. The perception of the relationship between banks' competitiveness and their compliance with the BIS standard was also shared by the Japanese and the Taiwanese regulatory authorities and the countries' banks. A notable example of this was that a number of Japanese banks without the obligation to adopt the BIS standard under the Japanese regulations voluntarily complied with the BIS standard from the late 1980s to the mid-1990s to raise their market image. Yet, this finding of the common perception of market compliance pressures for the BIS standard in the three countries, in spite of a difference in the banks' market sensitivity, does not reject the hypothesis. The banks always had to care about their market images in order to raise and operate funds. As a result, they were highly sensitive to markets, even though some banks were more sensitive than others.

An interesting finding is that the perception of market compliance pressures did not exactly correspond to either type of market compliance pressures. Regulatory authorities and banks in the countries believed that compliance with the BIS standard *per se* was necessary for banks to raise or at least to maintain their competitiveness in markets. Nevertheless, most banks in the countries believed that comprehensive compliance with the BIS standard was *not* necessary to maintain their market competitiveness. Also, even though this study has not directly addressed whether the regulatory authorities perceived that market compliance pressure for the BIS standard was for comprehensive compliance or for formal compliance, the analysis of their implementation of the BIS standard has shown that such a perception did *not* lead the authorities to implement it in earnest. This deformed perception of market compliance pressures by the regulatory authorities and the banks appeared to be generated by various factors, such as general agreement on the necessity of capital adequacy regulation, information asymmetries in markets, the status of the BIS standard as the best practice, confusing signals from markets, and risk-averse attitudes.

In addition, it should be emphasised that banks opted to adopt the BIS standard only when their compliance costs were low. Indeed, although most Korean and Taiwanese banks were not opposed to the decision by their regulatory authorities to adopt the BIS standard, they did not lead the adoption. Most Korean banks' and a few Taiwanese banks' capital conditions were not strong enough to meet the required minimum CAR of 8 percent. In these circumstances, the implementation of the BIS standard could raise the risk that they would face regulatory action from the regulatory authorities. Also, as their capital condition deteriorated, and the PCA system was implemented, most Japanese banks abandoned the BIS standard to switch to the domestic capital adequacy regulation.

In regard to the operation of the domestic compliance mechanism, the first hypothesis was constructed as follows:

Hypothesis 7: the domestic compliance mechanism is more likely to operate when there is a high level of compatibility between domestic groups' preferences and both the overall objectives of the regime and its specific provisions.

This study has focused on bank regulatory authorities as the key potential domestic group to support compliance with the BIS standard, and its findings have strongly supported this hypothesis. When the Basel Accord was established, Japan maintained a

convoy system. The main purpose of the implementation of the convoy system was to strengthen the stability of the country's financial system. Therefore, the convoy system was not in conflict with the objectives of the Basel Accord. However, the convoy system did not allow banks to fail. Accordingly, the Japanese regulatory authority had not regarded capital adequacy regulation, of which the main purpose was to prevent bank failures, as necessary. Indeed, although there was a capital adequacy regulation prior to the adoption of the BIS standard, the regulatory authority had no strong willingness to enforce Japanese banks to comply with it. The attitude of the Japanese bank regulatory authorities towards capital adequacy regulation did not change until the mid-1990s, when the convoy system began to unravel. As a result, the regulatory authority did not penalise banks for their failure to comply with the BIS standard until the introduction of a PCA system in April 1998, even though it had the enforcement capacity. The condition for the operation of the domestic compliance mechanism was even weaker in Korea. The Korean regulatory authority had also maintained a "no bank failure" policy. Moreover, the regulatory authority had traditionally attached less attention to prudential regulation, sacrificing stability for growth when necessary. Consequently, the strengthening of bank capital adequacy had never been at the centre of banking regulation in the country until the outbreak of the 1997 financial crisis.

The second hypothesis with regard to the domestic compliance mechanism predicted:

Hypothesis 8: compatibility between domestic groups' preferences and an international regulatory regime is more likely when the following two conditions are met:

- . The domestic groups do not have prior, strong beliefs inconsistent with the objectives of the regime and its methods to achieve the objectives.*
- . The domestic groups are in new and uncertain environments.*

No direct evidence to prove the first element of the hypothesis has been found. It has, however, been indirectly supported by the initial wilful neglect of the BIS standard by the Japanese and Korean regulatory authorities. Meanwhile, the second element of the hypothesis has been proved. The Taiwanese regulatory authority expected that the implementation of the BIS standard would help maintain stability in the financial system, when stronger banking regulations were needed due to the liberalisation of the banking sector. Indeed, the regulatory authority did penalise banks that failed to comply

with the BIS standard throughout the whole observation period. The Japanese regulatory authority changed with the intention to strengthen the Japanese BIS standard from the late 1990s, during which time they began to perceive that the previous bank regulatory policy and the resulting weak capital soundness of banks was a major hindrance to the recovery of the economy. The Korean bank regulatory authority also put significant emphasis on comprehensive compliance with the BIS standard after the 1997 financial crisis, which was largely attributed to the failure of previous financial regulation.

The last main hypothesis regarding the domestic compliance mechanism was the following:

Hypothesis 9: The operation of the domestic compliance mechanism is likely to result in pressure for comprehensive compliance.

This study indicates strong evidence to uphold the hypothesis; whenever the regulatory authorities made a voluntary commitment to the BIS standard, they attempted to achieve comprehensive compliance. By incorporating the BIS standard within domestic banking regulations, the Taiwanese regulatory authority did not stray far from the provisions in the Basel Accord, and its implementation of the BIS standard was largely faithful until the mid-1990s. Moreover, as the capital soundness of Taiwanese banks deteriorated, the regulatory authority did build plans to improve it, including those to strengthen the rules on asset classification and provisions. Also, after the Japanese and Korean regulatory authorities made a voluntary commitment to the BIS standard, they worked for comprehensive compliance. The initial plan of the PFR was a clear reflection of such efforts by the Japanese regulatory authority. The Korean bank regulatory authority also led the upgrading of the bank regulations after the 1997 financial crisis.

Factors that affected implementation

This study also formulated three supplementary hypotheses relating to the effect of the domestic compliance mechanism, drawing particular attention to three factors that affect the implementation capacity of regulatory authority: the domestic distributional effects of compliance, the independence of the regulatory authority, and the capacity of the authority to effectively deal with compliance failures. In relation to the domestic distributional effects of compliance, the following hypothesis was constructed:

Hypothesis 10: *compliance failure is more likely to occur when compliance costs are diffused from regulatory targets to other sectors comprised of politically important actors.*

This hypothesis was strongly supported by the evidence and analysis. Notably, the regulatory targets' capacity to comply with the international regulatory regime was a critical factor that affected the diffusion of compliance costs from targets to other sectors of the economy. When the capital conditions of the overall banking sector were relatively sound, banks' compliance with the BIS standard did not substantially affect other sectors of the economy. However, as the capital conditions of a number of banks deteriorated, the costs of compliance with the BIS standard were partly transferred from the banks to the firms that relied on bank loans. The specific mechanism through which the compliance costs were transferred was a reduction in the volume of bank loans. A reduction in banks loans to raise the banks' BIS CARs caused firms to suffer from a credit squeeze. In these circumstances, even though the regulatory authorities were willing to achieve comprehensive compliance, and sometimes overcame opposition from banks, the authorities had to withdraw from rigorous enforcement of the relevant standards due to increasing domestic opposition from firms and from politicians to protect them.

There were two primary examples that showed the effect of the diffusion of compliance costs on reducing overall compliance with the BIS standard. One was the implementation of the BIS standard in Japan during the late 1990s and early 2000s. The Japanese regulatory authority attempted to strengthen the Japanese BIS standard during this period. The initial plan of the Financial Inspection Manual of 1998 was intended to adopt stricter regulations on asset classification and loan loss provisions. Also, the initial version of the PRF of 2002 included provisions such as limiting the inclusion of DTAs in the regulatory capital. However, these plans were abandoned due to opposition from banks that warned of a credit crunch and from politicians (the LDP) to protect firms. The other example was the implementation of the BIS standard in Korea in the period following the financial crisis. Although Korea's compliance during the post-crisis period was more comprehensive than during the earlier period, the further strengthening of compliance was failed due to domestic opposition, which was caused by a credit squeeze resulting from strict implementation of the BIS standard. In the case of Taiwan, although the corporate finance system was a bank-centred system, as it was in Japan and Korea, the disclosed capital condition of the overall banking sector was relatively sound,

partially due to regulatory forbearance. As a result, there was no credit crunch caused by the banks in Taiwan.

It was anticipated that institutional settings in the policy-making process would influence the compliance decisions of governments, and the following hypothesis was constructed as a result:

Hypothesis 11: *where the independence of regulatory authorities is lower, compliance failure is more likely to occur, even if the regulatory authorities themselves favour compliance.*

The negative effects of the limited independence of regulatory authorities from political intervention on compliance with the BIS standard were evidenced in all three countries. As discussed above, the Japanese regulatory authority's attempts to strengthen the Japanese BIS standard during the late 1990s and the early 2000s were overruled by pressure from politicians to protect SMEs. The flexible implementation of the BIS standard in Korea during the early 2000s resulted from the lack of independence of the FSC from the government, especially from the MFK.⁴⁷⁴ In addition, the cosy relationship between politicians and businesses was likely to have hindered the MFT in addressing NPL problems in Taiwan during the second half of the 1990s.

In this regard, a noteworthy finding is that the formal independence of regulatory authorities based on official institutional arrangements did not necessarily increase their policy autonomy. Although Japan's FSA was an external agency of the Cabinet Office, there were a range of formal and informal institutional factors that reduced the policy autonomy of the FSA from the ruling party. The independence of the FSC was embodied in law, but its policy autonomy was in practice undermined by the MFK. The legal independence of bank regulatory authorities without actual policy autonomy made few contributions to strengthening their capacity to implement their own policy objectives.

Finally, as regards compliance capacity, the following hypothesis was proposed:

Hypothesis 12: *when the cost of compliance for regulatory targets in a country is high,*

⁴⁷⁴ During the pre-crisis period, the OBS was subordinated to the MFK. However, at the time, the relations between the two bodies hindered the OBS from paying much attention to prudential regulation, including capital adequacy regulations. As a result, the OBS did not demand comprehensive compliance with the BIS standard.

and the government lacks the capacity to deal with compliance failures by the regulatory targets, cosmetic compliance is more likely to occur.

This hypothesis has been supported by evidence of cosmetic compliance with the BIS standard in Japan during the mid-1990s and in Taiwan during the second half of the 1990s and early 2000s. Japan's traditional financial safety net, the convoy system, began to unravel in the mid-1990s. Meanwhile, the deposit insurance system, which was intended to compensate for the decline of the convoy system, had not sufficiently developed, due to political reasons. In these circumstances, the MFJ could not disclose the true size of NPLs, because the full disclosure could have led the CARs of a large number of the banks to drop below the 8 percent minimum, possibly triggering financial instability. Taiwan's cosmetic compliance during the second half of the 1990s and early 2000s was also largely due to the lack of an appropriate financial safety net. While the number of private banks increased sharply, the official resources that could be used to handle ailing banks were very limited. Even though the government established a plan to strengthen the financial safety net, it was rejected by the Legislative Yuan, which was dominated by the opposition parties, in a volatile political situation. As a result, the MFT could not implement the BIS standard more strictly, because it could have aggravated instability in the financial system in the short term.

In addition, note that the lack of capacity to deal with compliance failures contributed to cosmetic compliance in Korea during the pre-crisis period. In the country, as the "no bank failure" policy was still effective, failure to comply with the BIS standard was believed to be unlikely to cause a financial crisis despite the absence of an adequate formal financial safety net during the pre-crisis period. However, the economic growth of the country relied significantly on the foreign capital that banks provided to the economy, while banks' noncompliance with the BIS standard was expected to raise their costs of borrowing in international financial markets. In this situation, the government had to help banks formally comply with the BIS standard by exercising regulatory forbearance, due to the potential negative consequences that compliance failure could cause to the overall economy. Accordingly, this capacity problem in Korea was resource-driven, while that in Japan or Taiwan was political in essence.

The comparison of the case countries

This section identifies the differences in compliance with the BIS standard between the

three cases more explicitly. Issues related to formal compliance are first discussed, followed by an analysis of issues relating to comprehensive compliance.

Although formal compliance with the BIS standard was generally quite good in all the case countries, there were noticeable differences between them. In terms of the frequency of compliance failure, formal compliance was higher in Japan than in Korea or in Taiwan. All Japanese BIS-standard banks complied with the minimum CAR requirement of 8 percent most years between 1992 and 2002; when compliance failures occurred, only 1 to 3 percent of the total BIS-standard banks failed to meet the required 8 percent minimum. In the case of Korean banks, there were only two compliance failures between 1993 and 1996, and all of them complied with the required minimum CAR of 8 percent between 2000 and 2003. However, the BIS CARs of most Korean banks fell below 8 percent in 1997 and 1998 in the wake of the 1997 financial crisis, though the CARs began to recover in 1999. Meanwhile, compliance failures by Taiwanese banks occurred every year between 1993 and 2003, and the number of noncompliant banks reached 2 to 12 percent of the total (BIS-standard) banks. These formal compliance records of the three countries are intriguing, considering that cosmetic compliance was persistent in Japan throughout the 1990s and early 2000s, while compliance with the BIS standard shifted from cosmetic to more comprehensive compliance in Korea after the 1997 financial crisis and Taiwan's compliance was comprehensive until the mid-1990s. Accordingly, it is apparent that a country's formal compliance with the BIS standard did not necessarily reflect the effectiveness of the BIS standard in the country.

In addition, the analysis of formal compliance with the capital adequacy regulations in the case countries demonstrates that potential penalties from the domestic regulatory authorities for noncompliance with the regulations gave the principal incentive for banks to maintain formal compliance. In Korea and Taiwan, regulatory penalties for noncompliance with the BIS standard were explicitly laid down in the countries' banking regulations. In contrast, in Japan there was no formal enforcement mechanism that the regulatory authority could employ to penalise banks for noncompliance with the capital adequacy regulations, either the BIS-standard or domestic standard, until the introduction of the PCA system in 1998 (in 1999 for domestic standard banks). As a result, Korean and Taiwanese banks, including those that faced little compliance pressure from foreign countries or markets, tried to maintain their BIS CARs above the required 8 percent minimum in order to avoid regulatory penalties, though a few of them *failed* to clear the required minimum. In contrast, about 20 percent of Japanese

banks subject to the domestic capital adequacy regulations did not comply with the required minimum CAR of 4 percent during the pre-PCA period;⁴⁷⁵ however, most of them complied with the regulations after the introduction of the PCA system.

Importantly, insofar as regulatory penalties for noncompliance existed explicitly, the fact that the regulatory authorities had the discretion to actually punish banks for noncompliance did not reduce banks' incentives to comply with the regulations. The Korean regulatory authority (until the introduction of the PCA system in 1998) and the Taiwanese regulatory authority had such discretion, but Korean and Taiwanese banks showed a strong willingness to comply with the BIS standard in order to avoid potential penalties from the domestic regulatory authorities. In other words, the domestic legislation of regulatory penalties for noncompliance with the relevant capital adequacy regulations had a significant effect on banks' behaviour in the three case countries.

As for comprehensive compliance, this study has indicated that the degree of comprehensive compliance was high in two cases during certain periods, even though they had some caveats: Taiwan during the early 1990s, and Korea during the late 1990s and early 2000s. The high degree of comprehensive compliance in these cases becomes clear when they are compared with other cases by using banks' BIS CARs and their ratios of loan loss provisions to NPLs, although it is submitted that there are some problems with such a comparison.⁴⁷⁶

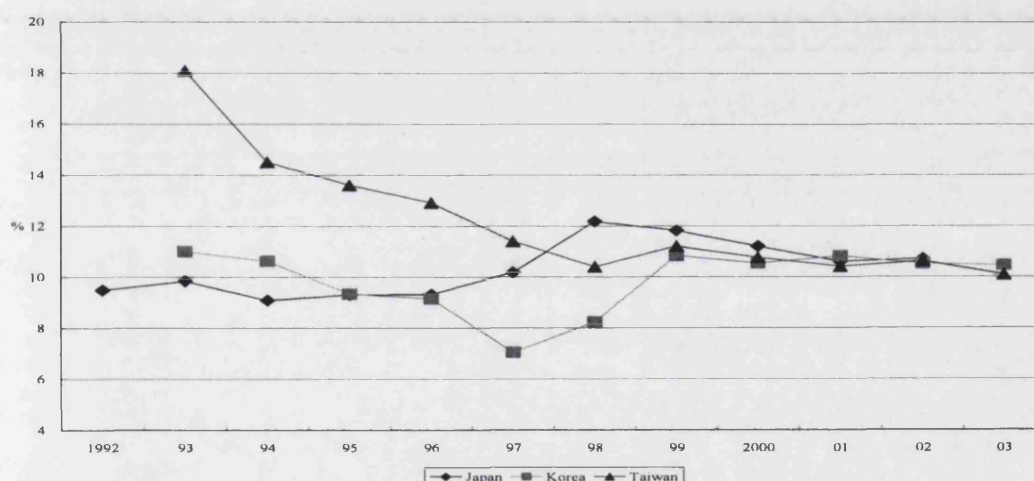
Figure 8.1 shows that Taiwanese banks' disclosed BIS CARs were far higher than Japanese or Korean banks until the mid-1990s, while Figure 8.2 indicates that the loan loss provisions to NPLs ratio was much higher for Taiwanese banks than for Japanese or Korean banks during the early 1990s. The definitions of NPLs in the countries were largely comparable until the mid-1990s, in principle covering only loans in arrears for

⁴⁷⁵ The noncompliance by the Japanese banks was not the result of the strict implementation of the domestic capital standard by the Japanese regulatory authority, but stemmed from the banks' low willingness to comply with the standard. As discussed earlier, there was no legal basis for the Japanese regulatory authority to enforce banks' compliance with the capital adequacy regulations during the pre-PCA period. In addition, the Japanese regulatory authority had no desire to enforce banks to comply with the regulations during the period. Also, note that even if most of Japanese banks subject to the BIS standard met the required minimum CAR of 8 percent during the pre-PCA period, these banks' formal compliance with the BIS standard was caused by the operation of the external compliance mechanisms. Yet, it should be emphasised that the effectiveness of the external compliance mechanisms in inducing banks to formally comply with the BIS standard was lower than that of domestic regulatory enforcement. This was because the latter posed an immediate threat to banks' managerial freedom, the primary concern of most banks, while penalties for noncompliance from foreign countries or from markets did not, and mainly limited the business activities of banks.

⁴⁷⁶ The problems in comparing the degree of comprehensive compliance across the case countries include the fact that it is not possible to address all factors inflating banks' BIS CARs and that the factors raising banks' BIS CARs were not identical across the countries.

more than six months. There was no significant regulatory forbearance related to bank capital adequacy regulations in Taiwan during the first half of the 1990s, and the financial condition of Taiwanese banks was sound during this period. Therefore, even though the lenient definition of NPLs increased Taiwanese banks' BIS CARs to some extent, the increase was not likely to be substantial. In short, Taiwanese banks' disclosed BIS CARs reflected their actual capital soundness to a large extent. By contrast, Japanese and Korean banks' low ratios of loan loss provisions suggest that these banks' BIS CARs should have been substantially discounted in order to reflect their true capital adequacy. Accordingly, it is plausible to conclude that Taiwan's degree of comprehensive compliance with the BIS standard was much higher than Japan's or Korea's during the early 1990s.

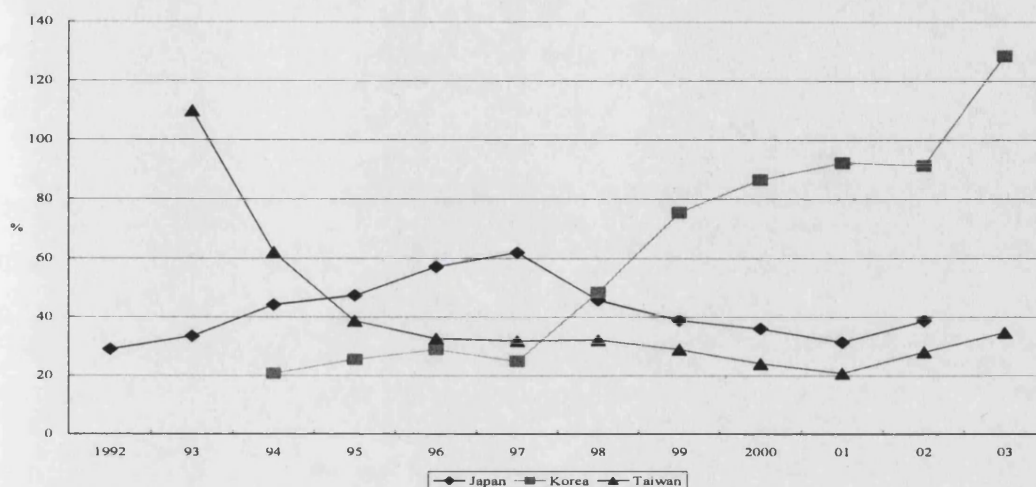
Figure 8.1 BIS CARs of banks by country, 1992-2003
(end of period; %)



Source: Japanese Bankers Association, various issues of *Zenkoku Ginkou Zaimushyohyou Bunseki* (Analysis of Financial Statements of All Banks); Office of Bank Supervision (1993-1998) and Financial Supervisory Service (1999-2003), various issues of *Unhaeng Gyeong-yeong Tonggae* (Bank Statistics); Central Bank of China, various issues of *Benguo Yinhang Yingyun Jixiao Jibao* (Conditions and Performance of Domestic Banks).

Note: The BIS CARs are those of banks subject to the BIS standard. Japanese banks' BIS CARs are those at the end of the fiscal years.

Figure 8.2 Loan loss provisions to NPLs ratio of banks by country, 1992-2003
(end of period: %)



Source: Financial Services Agency, *Total Losses on Disposal of Non-Performing Loans of All Banks*, 2003; the author's calculation from Financial Supervisory Service, various issues of *Unhaeng Gyeongyeong Tonggye* (Bank Statistics); Central Bank of China, various issues of *Benguo Yinhang Yingyun Jixiao Jibao* (Conditions and Performance of Domestic Banks).

Note: The figures are those of all Japanese major banks, all Korean commercial banks, and all Taiwanese banks. Japanese banks' figures are those at the end of the fiscal years.

Meanwhile, the loan loss provisions ratios in the three countries during the mid-1990s show that the degree of comprehensive compliance was low in all the countries during this period. The ratio was somewhat higher in Japan than in Korea or Taiwan, but the difference between the countries during this period was much less significant than during the earlier or the later period. In addition, the BIS CARs of Japanese banks were lower than those of Taiwanese banks and on a par with those of Korean banks' during this period. Therefore, it is reasonable to conclude that there was no significant difference between the three countries in the degree of comprehensive compliance during the mid-1990s. All the countries' compliance with the BIS standard was cosmetic during this period.

Yet, during the late 1990s and early 2000s, although banks' BIS CARs were between 10 and 12 percent level in each of the three countries, the banks' loan loss provisions ratios were much higher in Korea than in Japan or in Taiwan. The definition of NPLs was stronger in Korea and Japan than in Taiwan. Although the Korean regulatory authority exercised regulatory forbearance in bank capital adequacy regulation during this period, the inflation of Korean banks' BIS CARs by regulatory forbearance was not likely to be significantly larger than an increase in Japanese or Taiwanese banks' CARs caused by regulatory forbearance in Japan and Taiwan respectively. Accordingly, it can be evaluated that the degree of comprehensive

compliance was higher in Korea than in Japan or Taiwan during this period. Moreover, when comparing Korea's compliance before the late 1990s with the later period, it is clear that Korea's compliance shifted from cosmetic to more comprehensive during the later period.

Why did a high level of comprehensive compliance occur in Taiwan during the early 1990s and in Korea during the late 1990s and the early 2000s? Why not in Japan? A key necessary condition for comprehensive compliance with the BIS standard was the operation of the domestic compliance mechanism, which was generated when there was a high compatibility between the preferences of the regulatory authority and the objectives and provisions of the BIS standard. Until the late 1980s, the compatibility was low in all three case countries because the regulatory arrangements in these countries did not allow banks to fail, while the main purpose of the BIS standard was to prevent bank failures. Yet, the compatibility increased in Taiwan in the late 1980s, when the regulatory authority needed a new regulation for preventing failures of new private banks. The Taiwanese regulatory authority expected that the implementation of the BIS standard would help maintain financial stability, which had been traditionally their major policy objective. As a result, the Taiwanese regulatory authority implemented the BIS strictly, in contrast to their Japanese or Korean counterparts, at least until the mid-1990s, when factors emerged to hinder strict implementation of the BIS standard. A shift in Korea's compliance with the BIS standard from cosmetic to more comprehensive during the late 1990s and in the early 2000s also resulted from the operation of the domestic compliance mechanism, which was caused by the 1997 financial crisis; the financial crisis led the Korean regulatory authority to place unprecedented emphasis on prudential regulation, including strengthening of the Korean BIS standard.

The importance of the operation of the domestic compliance mechanism vis-à-vis the external compliance mechanisms in inducing comprehensive compliance can be evaluated from the fact that external compliance pressures appeared to be far higher on Japan than on Taiwan (and on Korea) during the first half of the 1990s. As Table 4.1 and Table 4.2 show, Japanese banks' engagement in international banking was far higher than Taiwanese banks. As a result, there were stronger external pressures to formally comply with the BIS standard on Japanese banks than on Taiwanese banks; Japanese banks were more vulnerable to these pressures than Taiwanese banks were. However, there was no substantial external pressure on the case countries for comprehensive compliance with the BIS standard. Exceptionally, Korea faced external pressure for

comprehensive compliance when it was under the IMF programme. Yet, even in this case, the IMF could not effectively impose its policy recommendations on Korea. The strengthening of compliance with the BIS standard in Korea was mainly led by the Korean regulatory authority, as it was shown that the country's degree of compliance after the end of the IMF programme was higher than that under the IMF programme.

Of course, the operation of the domestic compliance mechanism did not always result in comprehensive compliance. Cosmetic compliance in Japan during the late 1990s and early 2000s, and in Taiwan from the mid-1990s, demonstrated that the regulatory authorities failed to achieve comprehensive compliance despite their willingness to do so. The Taiwan's cosmetic compliance was mainly caused by the lack of capacity to deal with insolvent banks, which was due to political factors.⁴⁷⁷ The Japan's cosmetic compliance was due to the diffusion of compliance costs from the regulatory targets, the banks, to a politically important sector, SMEs, and the limited independence of the Japanese regulatory authority from government. In fact, the factors that caused Japan's cosmetic compliance during this period also hindered the Korean regulatory authority in achieving more comprehensive compliance during the post-crisis period.⁴⁷⁸ The effectiveness of the domestic compliance mechanism in ensuring comprehensive compliance was affected by the capacity to deal with banks' compliance failures, the domestic distributional effects of compliance, and the independence of the regulatory authority from the government and political pressures.

⁴⁷⁷ The capacity problem also led the Korean and Japanese regulatory authorities to implement the BIS standard leniently during the mid-1990s. However, the regulatory authorities did not establish explicit plans to strengthen their capital adequacy regulations during this period. In other words, the operation of the domestic compliance mechanism was not strong in Korea and Japan during this period.

⁴⁷⁸ The higher degree of comprehensive compliance in Korea compared to Japan during the late 1990s and early 2000s was attributable to the huge adverse effects of the 1997 financial crisis on Korea. Japan's financial system was also in a crisis during the late 1990s, when a number of large financial institutions collapsed. However, there was a significant difference between Japan and Korea in the severity of the crisis, since Korea was bailed out by the IMF. As a result, in Korea, the government itself, including the MFK, put a high emphasis on bank capital adequacy regulations after the financial crisis, although the political environment led it to respond to domestic demand to ease the implementation of the BIS standard. Meanwhile, in Japan, even the regulatory authority itself did not put much emphasis on the BIS standard *per se*. The Japanese regulatory authority intended to strengthen the Japanese BIS standard primarily because it perceived that the weak capital soundness of Japanese banks hindered the country's economic recovery. The difference in the severity of the crisis between the countries led to a difference between Japan and Korea in the degree of permissible regulatory forbearance in the area of bank capital adequacy regulations; in other words, there was a difference in the extent to which the domestic compliance mechanism operated in Japan and Korea.

8.2 Contributions to the study of compliance

The cases and the evidence presented in this study illuminate the following aspects of compliance with international regulatory regimes. First, international regulatory regimes can be effective only when they achieve their objectives; formal compliance with only their explicit provisions does not necessarily improve the effectiveness of the regimes. Thus, for the study of compliance with an international regulatory regime to have meaning for this critical issue of regime effectiveness, a close examination of the nature of the compliance—cosmetic or comprehensive—should be carried out. International regulatory regimes that allow more room for national discretion in implementing their provisions may be complied with by a larger number of countries, because their acceptability is high. Therefore, the importance of in-depth research on the nature of compliance increases for international regulatory regimes that are complied with by a large number of countries, in other words for seemingly more successful regimes. The effectiveness of an international regulatory regime should not be assessed merely in terms of the number of countries that formally comply with it.

Secondly, while external compliance pressures may induce formal compliance, they are less effective in promoting comprehensive compliance. At this point, it should be emphasised that the BIS standard was a least-likely case of noncompliance in terms of the exercising of external compliance pressures. This analysis of the establishment of the Basel Accord and its adoption in the three case countries has demonstrated that major countries in the international financial system intended to force or encourage other countries to comply with it, and additionally that all the case countries strongly believed the compliance pressures from other countries. Indeed, compliance pressures from foreign countries induced formal compliance with the BIS standard not only by Japan, but also by the non-members of the Accord, Korea and Taiwan. Nevertheless, there was no substantial foreign pressure on the countries to comply with the BIS standard comprehensively, except for Korea under the IMF programme.

One may ask whether the lack of extensive pressures for comprehensive compliance from foreign countries was due to the fact that the Basel Accord did not have a well-developed formal noncompliance response system. However, the absence of such a system is not a peculiar aspect of the Basel Accord, but a common characteristic of a growing number of “international standards”, or what is called “soft law”, which entails

no institutionalised enforcement by definition (Ho 2002: 650).⁴⁷⁹ Rather, a remarkable finding was that there was no pressure from foreign countries for comprehensive compliance with the BIS standard, even though they had an effective means of influencing the behaviour of banks operating in their countries, which was to close their markets to the banks.

The absence of extensive compliance pressure from foreign countries was due to the high political costs of exercising such pressure; there were no firm grounds for countries to force others to comply with the BIS standard comprehensively. Exceptionally, there was foreign pressure on Korea to comply with it comprehensively when the country was under the IMF programme. Yet, this was because the stand-by arrangement with the IMF lowered the costs for the IMF to exercise extensive pressure. In addition, the degree of negative externalities of a country's noncompliance with the BIS standard affected the incentives for foreign countries to force the country to comply with the standard. The lower the level of negative externalities of noncompliance, the lower the incentives were, and vice versa.

The likelihood of the exercising of market pressures to comply with the BIS standard was also high, given that the BIS standard was one of the most well-known regulations, even among financial regulations (FSF 2000b: 20). Nevertheless, the BIS standard, which was established by national regulators, failed to be accepted by market actors as a reliable regulation. In general, the likelihood that an international regulatory agreement is accepted by market actors is likely to be low when the agreement is designed to be applied to a large number of countries. This is because such an international agreement may set the level of regulation close to the point that appeals to the median country (see Gliberman and Singleton 2001: 3), and, as a result, the desirability of the regulations may decrease for other countries. Yet, as discussed earlier, even if market actors do not credit an international regulatory regime with a reliable regulation, market forces may enhance formal compliance with the regime insofar as market participants expect that noncompliant targets will be punished by regulatory authorities. Therefore, an important task for a study of the role of market forces in compliance is to distinguish clearly between these two kinds of market pressures, noting that their natures are different.

Thirdly, the operation of the domestic compliance mechanism may be necessary to induce comprehensive compliance, although the actual compliance outcome may be

⁴⁷⁹ For more on soft law, see Abbott and Snidal (2000).

affected by various domestic political economy factors. Remarkably, the emergence of domestic support for an international regulatory regime depends on any peculiar characteristics of the country's existing regulatory arrangements, rather than the *general* assessment of the regulatory regime. As indicated, the BIS standard was usually referred to as the international standard for bank capital adequacy regulation. Nevertheless, the necessity or the desirability of implementing the BIS standard appeared to be lower in a country whose banking system was less market-oriented; as a result, domestic support for the BIS standard was weak in the country. Without a country's endogenous support for an international regulatory regime, even if the country complies with it due to external pressures, the compliance is likely to be only cosmetic.

Fourthly, compliance capacity is a critical factor to determine compliance outcomes. Ironically, when a country faces substantial negative consequences due to its compliance failure, but lacks the capacity to deal with them, its compliance tends to be cosmetic. The more destructive the consequences of noncompliance with an international regulatory regime, the more efforts a country may make to comply with it. Under these circumstances, if they do not have the capacity to comprehensively comply with the regime, they exert themselves to maintain at least formal compliance with it. However, such compliance is likely to be cosmetic, as national authorities may actively reduce the compliance costs of the regulatory targets in order to help them comply with the regime. Importantly, capacity problems do not always stem from resource constraints *per se*. They can have political or institutional sources. Therefore, capacity problems can occur not only in less-developed countries, which tend to face resource constraints, but also in developed countries due to political reasons.

As a next step, even if a country has the systemic capacity to comply with an international regulatory regime, the domestic distributional effects of the regime affect the implementation capacity of national authorities to ensure that regulatory targets comply with the regime. In particular, this study has pointed out the adverse effects of compliance on a non-target sector comprised of politically important actors as a critical cause of compliance failure, going beyond the traditional focus on opposition from regulatory targets. This finding may be applicable to various other issue areas. Regulations in other financial sectors are strong candidates for the application of this finding, given that financial institutions are closely linked, in general, to other economic sectors. In this regard, it is noteworthy that a recent IMF report assessing the implementation of three international financial standards identified "public policy considerations" as a factor that caused regulatory forbearance (IMF 2004:21). Also, on

closer examination, it is clear that the cost of compliance with environmental, health or labour regulations is not exclusively imposed on the regulatory targets. Indeed, many environmental regulations affect not only regulated firms but also consumers, either directly, by raising the prices of particular commodities, or indirectly, by banning them from using particular products or requiring them to use them in a particular way (Vogel and Kessler 1998: 35).

When political struggles regarding compliance with an international regulatory regime emerge in a country, the compliance outcome is influenced by institutional arrangements that affect the regulatory policy-making process. This study has paid particular attention to the independence of regulatory authorities responsible for the issue areas, given that they are in a key position to affect overall compliance decisions. In this study, there were periods during which bank regulatory authorities acted as the major supporters for comprehensive compliance with the BIS standard. However, they were not able to implement the BIS standard in earnest when they lacked policy autonomy due to their lack of independence from governments or politicians. Of course, regulatory authorities' attitudes towards international regulatory regimes in other areas may be different; they can be the key opponents of some international regulatory regimes. Therefore, the analysis of regulatory authorities' attitudes towards an international regulatory regime should be preceded by a study of their independence.

Finally, this study suggests that it is necessary to rethink the desirability of compliance with certain international regulatory regimes. In general, studies on compliance—especially those addressing the issue from a perspective of international cooperation, and those that support international standards—tend to conceive of compliance in a positive sense. However, the findings in this research have demonstrated that international regulatory regimes may not always be desirable—at least not for all countries. There may be little objection to the Basel Accord's objective to strengthen the stability of the international banking system. However, the Accord's measures to achieve the objective did not always appear to be the optimal policy for every country. In addition, this study has shown that cosmetic compliance with the BIS standard occurred frequently due to concerns about a systemic financial crisis or the financial conditions of the corporate sector. In those circumstances, the enforcement of comprehensive compliance with the BIS standard may have had an adverse effect on the overall economy, at least in the short term. The presumption that compliance is always good should be avoided, even for international regimes that are generally regarded as an international standard or a best practice. Instead, the study of compliance should pay

more attention to the reasons that actors intend to comply with international regulatory regimes.

8.3 Contributions to international political economy

The findings of this thesis raise two broad questions for IPE scholarship. First, power in the global economy should be reconsidered. The underlying logic of the compliance mechanisms based on external pressures is that states and markets have the power to get others (states) to do things that they would not otherwise do. On the one hand, given that external compliance pressures did induce formal compliance, that power has been partly proved. As shown in the adoption of and compliance with the BIS standard in Korea and Taiwan, it may not be necessary that power is exerted by states or markets towards all other states in order to lead them to comply with the international regulatory regime of concern. Insofar as a state believes in the power of other states and markets to negatively affect its interests and anticipates that its compliance with the regime conforms to their desires, it appears to comply “voluntarily” with the regime in order to avoid the cost that it expects to otherwise bear.⁴⁸⁰ The state’s perception of the power of other states and markets appears to be influenced by its vulnerability to power resources that they can employ. Additionally, the anticipation of the exercise of power appears to be based on certain reasonable grounds.

On the other hand, this thesis has also drawn attention to the limitations of such power by demonstrating that the governments in the three case countries could manipulate the implementation of the BIS standard, thereby responding to domestic political and economic situations. In this study, I have argued that there was no strong signal that could lead bank regulatory authorities and banks in the case countries to anticipate that their cosmetic compliance with the BIS standard would be penalised by other states or by markets, in contrast to the case of external compliance pressures for formal compliance. The absence of such a signal was partially originated from the shortage of resources to monitor the nature of compliance and from the cost of exercising power to compel comprehensive compliance. Accordingly, I cast doubt on the case of “anticipated reactions,” which refers to situations in which “one actor, B, shapes his behaviour to conform to what he believes are the desires of another actor, A, *without* having received an explicit message about A’s wants or intentions from A or A’s

⁴⁸⁰ The role of implicit threats and perceptions in affecting states’ behaviours has been widely recognised by IR scholars. See, for example, Jervis (1976).

agent” (Nagel 1975: 16, emphasis added), especially under the circumstances in which such behaviour changes are costly to B.⁴⁸¹ For B to change her behaviour as an anticipated response to the power of A, there should be plausible grounds for B to believe that A is willing and able to exercise power over B. Of course, even if a country faces external pressures to change its regulations, the effectiveness of such pressures in ensuring the country’s regulatory changes may not be high without the domestic support for the changes, when the changes impose high costs on the country. Power does not come from the power holders alone, but from the relations between them and those interacting with them (Guzzini 1993: 452-453).

Secondly, this study raises a question about the significance of international regulatory harmonisation, as well as its desirability.⁴⁸² The study of international regulatory harmonisation has been a central theme of much recent IPE scholarship. In fact, the BIS standard has attracted much attention from IPE scholars as a primary example of international regulatory harmonisation. However, much research on the BIS standard from the perspective of harmonisation has addressed its establishment with almost exclusive focus on U.S. (and U.K.) policies, even though Japan was a key player in creating the Basel Accord. Also, although there are some studies that provide a theoretical framework to analyse the international harmonisation of the BIS standard beyond the Basel Committee, there has been little empirical research to address it. This thesis has filled some of the gaps in the literature on harmonisation by examining why Japan agreed to create the BIS standard and by exploring why Korea and Taiwan adopted it. The international harmonisation of the BIS standard was largely attributable to its status as *the* international standard or *the* best practice in the area of bank capital adequacy regulation, even though the status was constructed without a solid theoretical case.⁴⁸³ In this regard, it may be expected that a set of regulations established by an exclusive group of advanced countries submitting that they represent the international best practice or the global standard is likely to proliferate into other countries.

However, it is doubtful what contributions a *superficial* international harmonisation of the regulations can make to the world, even if it is presumed that they are actually best practice. Given the analysis of the actual capital adequacy of banks in the case countries, it is difficult to argue that the BIS standard has increased the soundness of the

⁴⁸¹ For anticipated reactions, see also Baldwin (1980: 499).

⁴⁸² David A. Singer (2004: 562-563) distinguishes harmonisation into three categories according to its nature.

⁴⁸³ In this regard, this research also carries implications for the study of the effects of international regimes.

international banking system.⁴⁸⁴ It was even difficult to compare the capital soundness of banks by using their disclosed CARs based on the BIS standard. Therefore, this study suggests that the analysis of harmonisation should pay equal attention to two related but separate issues—why countries make a commitment to a certain international regime, and how they actually implement the regime—to provide the meaning of international regulatory harmonisation.

8.4 Parting words

In June 2004, the Basel Committee established the new bank capital adequacy framework, which is commonly known as Basel II, by publishing *International Convergence of Capital Measurement and Capital Standards: A Revised Framework*.

The fundamental objective of Basel II is similar to that of the 1988 Basel Accord:

[t]o develop a framework that would further strengthen the soundness and stability of the international banking system while maintaining sufficient consistency that capital adequacy regulation will not be a significant source of competitive inequality among internationally active banks (BCBS 2004b: 2).

Basel II also retains some key elements of the 1988 Accord, including the general requirement for banks to hold a total capital equivalent to at least 8 percent of their risk-weighted assets, the basic structure of the 1996 Market Risk Amendment regarding the treatment of market risk, and the definition of eligible capital (BCBS 2004b: 2, 12).⁴⁸⁵

However, the creation of Basel II stemmed largely from the recognition that the 1988 Basel Accord has not kept pace with advances in risk management practices and, as a result, it may not reflect banks' actual business practices. Accordingly, although Basel II is built on the 1988 Accord's basic structure for setting capital requirements, it is substantially different from the previous framework. Basel II is based on "three pillars": minimum capital requirements (Pillar 1), supervisory review (Pillar 2), and market discipline (Pillar 3) (BCBS 2004b: 2). Pillar 1 aligns the minimum capital requirements more closely to each bank's actual risk of economic loss. Pillar 2

⁴⁸⁴ In fact, economists disagree over whether the imposition of capital requirements actually curtails or promotes bank performance and stability. See Barth, et al. (2001b: 9).

⁴⁸⁵ The required minimum CAR of 8 percent is not based on scientific reasons, but is a result of a concern to ensure some continuity between the 1988 Accord and Basel II, suggesting path dependence. (I thank Andrew Walter for this point.)

recognises the necessity of exercising effective supervisory review of banks' internal assessments of their overall risks to ensure that the bank's management is exercising sound judgement and has set aside adequate capital for these risks. Pillar 3 leverages the ability of market discipline to motivate prudent management by enhancing the degree of transparency in banks' public reporting (BCBS 2004a).

Under Pillar 1, higher levels of capital are required for borrowers carrying higher levels of credit risk, and vice versa. Also, banks and supervisors are allowed to choose, among three options, an approach that seems most appropriate for the level of sophistication of a bank's activities and internal controls. Banks with a more sophisticated business and more advanced risk measurement systems may, with the approval of their supervisors, select from one of two "internal ratings-based" approaches to credit risk, and, under the approach, banks rely partly on their own measures of borrowers' credit risk to determine their capital requirements. Meanwhile, banks with a less complex business and simpler control structures may use external measures of credit risk to assess the creditworthiness of borrowers under the "standardised approach." In addition, there is an explicit capital charge for a bank's exposures to operational risk, and, similar to the range of options provided for assessing exposures to credit risk, banks will choose one of three approaches for measuring their exposures to operation risk. Pillar 1 allows banks adopting more comprehensive and accurate measures of risk as well as more effective processes for controlling their exposures to risk to maintain lower capital levels. Under Pillar 2, supervisors will determine whether banks should hold higher levels of capital than the minimum requirements in Pillar 1 would specify and whether there is any need for remedial actions, by evaluating the activities and risk profiles of the banks. Pillar 3 sets out the public disclosures that banks must make that lend greater insight into the adequacy of their capitalisation. The introduction of Pillar 3 is a reflection of the Committee's belief that, when market participants have a sufficient understanding of a bank's activities and the controls it has in place to manage its exposures, they are better able to distinguish between banks so that they can reward those that manage their risks prudently and penalise those that do not (BCBS 2004a).

There are a few significant factors that may lead observers to anticipate high levels of compliance with Basel II. The Committee has explicitly emphasised comprehensive compliance, as shown in the phase, "the Committee expects national supervisors will focus on compliance with the minimum requirements as a means of ensuring the overall integrity of a bank's ability to provide prudential inputs to the capital calculations and

not as an end in itself” (BCBS 2004b: 2, emphasis added). Also, in contrast to the 1988 Accord, the Committee intends to monitor and review the application of Basel II. Indeed, the Committee established the Accord Implementation Group to promote consistency in Basel II application by encouraging supervisors to exchange information on implementation approaches (BCBS 2004b: 2). In other words, Basel II appears to be equipped with a formal compliance monitoring system at the inter-national level. Moreover, Pillar 3 is directly intended to enhance the role of markets in ensuring the capital adequacy of banks (see BCBS 2004b: 175-190). In addition, Pillar 2 requires national authorities to strengthen their supervision of banks’ compliance with regulatory capital ratios (see BCBS 2004b: 158-174).

Basel II has replaced the status of the 1988 Accord as the best practice for capital adequacy regulation, and has already begun to proliferate globally. G10 countries are expected to implement Base II from 2006, and non-G10 countries have been encouraged by the Committee to adopt it (BCBS 2004b: 1). Indeed, a good number of non-G10 countries, including Korea and Taiwan, have announced their plans to implement Basel II, although the Committee has recommended that “they proceed at their own pace, based on their own priorities” (BCBS 2004a). What is actual compliance with Basel II? What determines compliance with it? Is compliance with Basel II different from compliance with the 1988 Accord? If so, what explains the difference? As discussed above, Basel II includes some significant factors to increase the operation of both external and domestic compliance mechanisms, even for comprehensive compliance. Therefore, compliance with Basel II is likely to be higher than that with the 1988 Accord. Yet, it still remains doubtful whether such factors will actually be effective in inducing compliance. Future research should address these questions more systematically in order to increase understanding of contemporary global governance. It is hoped that this study will serve as a platform from which future studies of these important questions may be undertaken.

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**Explaining Cosmetic Compliance with International
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Explaining Cosmetic Compliance with International Regulatory Regimes: The Implementation of the Basle Accord in Japan, 1998-2003

HYOUNG-KYU CHEY

A central theme of much recent IPE scholarship has been the question of what determines compliance with international regulatory regimes.¹ The contemporary debate on the issue centres around three competing perspectives on addressing non-compliance: enforcement, management, and market-based.² Enforcement theorists stress coercive measures against non-compliant states by other states. Management theorists emphasise a problem-solving approach, such as building transparent information systems. The market-based approach argues that market forces can enhance compliance. Although these compliance strategies may reflect important aspects of non-compliance, all these perspectives mostly diagnose and seek to resolve compliance problems at the systemic level. As a result, the analysis of domestic political causes of non-compliance is still in its early stage, not going much beyond indicating opposition from regulatory targets as the major cause.³ Moreover, much research from all three perspectives limits its analytic focus to formal compliance with *explicit* rules of regimes, while defining non-compliance strictly as behaviour in breach of them.⁴ Consequently, non-compliance in a broader sense and the effectiveness of the compliance strategies in addressing such non-compliance are still vastly underexplored.⁵ This article attempts to fill some of these important gaps in the literature by presenting an in-depth study on a specific but prevalent form of non-compliance.

In certain circumstances, governments manipulate the implementation of a regulatory regime in their jurisdictions to help the regulatory-target firms formally comply with its explicit provisions, but still allow them, in practice, to defect from its objectives. In this situation, both the governments and the regulatory targets are in formal compliance, but the formal compliance is only *cosmetic*. Cosmetic compliance should be considered a form of non-compliance in terms of regime effectiveness, which is the fundamental issue of compliance, because regimes facing it cannot solve the problems they were established to solve. A growing number of studies suggest that cosmetic compliance is *not* an extraordinary problem but a common, serious challenge

to various environmental and financial regulatory regimes.⁶ This study provides an explanation as to why cosmetic compliance occurs, by examining the effectiveness of compliance strategies proposed by the three perspectives to constrain it and, going further, by conducting a deep analysis of domestic political causes of non-compliance.

I argue that compliance strategies relying on external pressures are not an effective means to restrain cosmetic compliance, although they may induce formal compliance. Comprehensive compliance—in other words, compliance with not only the explicit provisions but also the objectives of regimes—fundamentally relies on the willingness and capacity of national authorities. Second, I identify a salient channel through which domestic opposition to compliance with an international regulatory regime can be magnified: diffusion of compliance costs from the regulatory targets to *non-target* sectors which are politically important groups. In these circumstances, even if national regulatory authorities are willing to comply with the regime in earnest and overcome opposition from the regulatory targets, they may fail to achieve comprehensive compliance.

To develop these claims, this study addresses compliance with the Basle Accord of 1988 (the BIS bank capital adequacy standard) in Japan during the period of 1998 to 2003.⁷ The BIS standard has symbolic significance for regime compliance, given that it has been a keystone of financial regulatory regimes over the past two decades, by being adopted by more than 100 countries. Moreover, the BIS standard may provide a useful example of cosmetic compliance, as it presents a least-likely case of non-compliance:⁸ bank regulatory authorities have had strong incentives to ensure sound bank capital regulations in other countries due to the high possibility that any bank failures in the dense network of interbank relations can cause systemic instability in the international financial system;⁹ and the BIS standard has been a most well-known regulation to market actors, even among financial regulations.¹⁰ In addition, Japan was carefully selected to minimise the limitations of a single-case study: Japan was under strong pressure from the US and the UK to agree to create the Accord;¹¹ the fact that Japanese banks faced a Japan premium in raising funds during the mid-1990s suggests that markets could respond to a change in the soundness of Japanese banks;¹² and, as will be discussed later, Japan's bank regulatory authority did have the intention to work for comprehensive compliance with the BIS standard. Thus, Japan's cosmetic compliance with the BIS standard can provide some support for the inference that cosmetic compliance is even more likely to occur in other countries and in other regulatory areas, such as environment, health, or labour.

This article proceeds as follows. I first review the literature on compliance and outline the basic argument. Next, I give a brief introduction to the Basle Accord and assess the compliance of Japanese banks with the BIS standard. In the following section, I examine whether there was external compliance pressure to hinder Japan in cosmetically complying with the BIS standard. I then analyse the factors that led Japanese authorities to exercise regulatory forbearance in implementing the BIS standard. I offer conclusions in the final section.

Compliance theory and cosmetic compliance

What determines compliance with international regulatory regimes? The two traditional perspectives on this compliance puzzle are referred to as the enforcement school and the management school. In addition to these dominating perspectives, a growing number of recent studies have developed the claim that market forces can facilitate compliance. In this section, I review these three compliance theories and develop the main argument of this article.

Enforcement theorists conceive states as rational actors that make compliance decisions based on cost/benefit calculations.¹³ ‘Collaboration’ regimes, in which states have mixed motives (to cooperate and to defect), are prone to non-compliance because states can take advantage of another’s compliance by defecting from the regimes.¹⁴ Thus, to ensure compliance, defection has to be monitored and punished by other states to hurt the transgressor states to a point at least equal to that which could be gained by the violation.¹⁵ The enforcement strategy may work effectively if the costs to the states imposing sanctions on defectors are not high, and the sanctions are specifically targeted at violators.¹⁶ With regard to the Basle Accord, studies of its establishment suggest that the dominant powers in the international financial system—the US and the UK—had a strong intention of forcing other countries to comply with it.¹⁷

Market-based theorists argue that market forces can facilitate compliance with international regulatory regimes that are accepted by the market.¹⁸ Market actors monitor the regulatory targets’ compliance and force them to abide by the regimes by punishing them if they do not. Non-compliant regulatory targets are penalised in markets because they are considered non-competitive by market participants.¹⁹ A noteworthy element of the market-based approach is that the importance of national authorities’ capacity to implement regulations in ensuring the regulatory targets’ compliance with them may decrease under the operation of compliance pressures from

markets. Market forces can compel the regulatory targets to comply with the regulations by directly affecting the cost/benefit calculations of their compliance.²⁰ Indeed, the Basle Committee, which established the Basle Accord, and a group of political economists have attributed the voluntary compliance of non-Committee countries with the BIS standard to competitive pressure on banks exerted by markets.²¹

In contrast to the two foregoing compliance approaches, the management school is doubtful about the effectiveness of external pressure in ensuring compliance.²² Management theorists argue that compliance with international agreements is generally quite good and that enforcement has played little role in achieving the high level of compliance.²³ Non-compliance is not necessarily, or not even usually, the result of a deliberate decision based on a cost/benefit calculation.²⁴ Instead, it may occur due to the ambiguity of international agreements, limitations on capacity or unexpected social and economic changes.²⁵ Accordingly, management theorists argue that non-compliance can be addressed by managerial solutions rather than formal enforcement measures or coercive informal sanctions, except in egregious cases. Managerial strategies for compliance involve the improvement of dispute resolution procedures, technical and financial assistance, the development of transparent information systems, and so forth.²⁶

How effective are the compliance strategies proposed by the three schools of thought in constraining cosmetic compliance? Enforcement strategies are not likely to be easily resorted to by a state to punish another's cosmetic compliance. Even if cosmetic compliance with an international regulatory agreement is detected, it would be difficult to say with precision whether it is a violation of the agreement from the legal perspective. Even some 'defections' may stem from the areas that the international agreement does not formally address.²⁷ Insofar as 'transgressor' states are in compliance with the formal provisions of the agreement, imposing sanctions on their defection from its object is likely to be politically costly to the punishing states.

As to the market-based approach, if market participants approve of both the object and the provisions of a regulatory regime, market forces may facilitate comprehensive compliance with the regime. Yet, the primary condition for the operation of market pressures for comprehensive compliance is not likely to be easily met. For such market pressures to operate, international agreements established by national regulators have to be accepted by market participants as reliable regulations. In general, national regulators tend to put more weight on the public-good aspect of regulations, while market participants weigh their efficiency more heavily. In this situation, it may not be difficult to see that although market participants agree on the desirability of regulation, they do

not agree on regulations set by national regulators. Moreover, although the regulations are initially accepted by the market as dependable ones, market participants' scepticism of them may increase over time as they become outmoded. Yet, note that even though market actors do not credit the provisions of an international regulatory agreement with appropriate regulations, regulatory targets failing to comply with the provisions *formally* may be punished in markets. This is because non-compliant regulatory targets may face penalties from the regulatory authorities, which has negative effects on the regulatory targets' business. Thus, whereas the likelihood that market pressures for comprehensive compliance operate is not high, formal compliance may be enhanced by markets.

Therefore, although external pressures, from states or from markets, may induce formal compliance, they are not likely to be effective in strengthening comprehensive compliance. Accordingly, comprehensive compliance may depend primarily on the willingness and ability of national authorities to ensure it. In this article, I do not directly address whether the compliance strategies proposed by the management school are conducive to inducing comprehensive compliance; instead, I develop their argument of causes of non-compliance, in particular capacity problems, indirectly supporting managerial solutions as a means to constrain cosmetic compliance. Capacity limitations stem from diverse sources, administrative, economic or political.²⁸ Among these, political capacity problems are of particular interest to this study, because administrative or economic limitations are frequently the result of political problems.

The domestic distributional effects of an international regulatory regime affect the political capacity of national authorities to ensure the regulatory targets comply with the regime. It may be obvious that the regulatory targets' opposition to compliance with the regime will increase as their compliance costs grow. Yet, importantly, the costs of complying with the regime can be diffused from the regulatory targets to other sectors of the economy. If the sectors negatively affected by the regulatory targets' compliance are politically important or influential, and the sectors' damage is substantial, the likelihood of political intervention to oppose compliance in order to protect these non-target sectors will increase. Under the circumstances, even if the national regulatory authority is willing to force the regulatory targets to comply with the regime in earnest and can overcome the regulatory targets' own opposition, the regulatory authority may fail to implement the regime in earnest. In this article, I show how this mechanism of compliance failure actually occurred for the Basle Accord in Japan.

The Basle Accord and Japan's illusory compliance

The Basle Committee, which consisted of bank regulatory authorities from G-10 countries, established the Basle Accord in 1988 with two objectives—to strengthen the soundness of the international banking system, and to level the playing field for international banks. The Accord formulated a common framework to measure banks' capital adequacy ratios (CARs), and set a required minimum CAR at 8 per cent. The CAR in the framework (hereafter BIS CAR) was computed by dividing total capital by risk-weighted assets on a consolidated basis. Capital was divided into tier 1 capital (core capital) and tier 2 capital (supplementary capital). The total of tier 2 elements was limited to a maximum of 100 per cent of the total of tier 1 elements. A risk weight of 0, 10, 20, 50, or 100 per cent was applied to assets according to their types. The BIS capital adequacy standard was formally intended to be fully applied to international banks from the end of 1992, although the definition of international bank was not clearly given in the Accord.

Japan's bank regulatory authority narrowly defined 'international bank' as a bank with overseas branches or representative offices, and required that they meet the BIS standard from the end of March 1993 (Japanese 1992 fiscal year-end). The implementation of the BIS standard in Japan during the late 1990s to early 2000s is particularly interesting in that the regulatory authority aggressively exercised regulatory forbearance in the area of bank capital adequacy, whereas a Prompt Corrective Action (PCA) system, which required the authority to take punitive actions against banks automatically when their BIS CARs fell below the regulatory minimum of 8 per cent, was implemented from April 1998.²⁹

Japanese banks, on the surface, showed a good record of compliance with the Basle Accord during the PCA period, although Japan's prolonged economic recession throughout the 1990s and the early 2000s put heavy downward pressure on their CARs. The banks were able to withstand the downward pressure until the mid-1990s, partly relying on unrealised gains on securities holdings, which was a tier 2 capital element, or utilising asset securitisation or new capital instruments such as subordinated debt and preferred stocks. However, the value of the unrealised gains became negative in 1998. The banks' losses on disposal of non-performing loans surpassed their operating profits from the mid-1990s, encroaching on their capital. Meanwhile, they faced serious difficulties in raising new capital at affordable rates during the economic recession. Nevertheless, most of the banks that adopted the BIS standard complied with the

required 8 per cent minimum; there were only two compliance failures by the banks per year between fiscal years 1998 and 2002. As well, their BIS CARs on average surpassed 10 per cent during the period.

However, the record of Japanese banks on formal compliance with the BIS standard was illusory. The number of banks that employed the BIS standard sharply declined from April 1998, when the PCA system took effect. One day before the implementation of the PCA system, the Japanese regulatory authority abolished a regulation that prevented a bank that had adopted the BIS standard from switching to the domestic capital standard, which set the required minimum CAR at 4 per cent.³⁰ Half of the banks that had employed the BIS standard switched to the domestic standard on that day. The number of banks that adopted the BIS standard continued to decline until, in March 2003, only about 10 per cent of all Japanese banks adhered to it (see Table 1). It should be noted that, although the banks that switched to the domestic capital standard were not 'international banks' under the narrow Japanese definition of that term, they did engage in international business activities by undertaking transactions with foreign banks. In fact, in most countries, the BIS standard was applied to all (commercial) banks.

Table 1. The number of Japanese banks that adopted the BIS standard
(fiscal year end; number)

| | 1993 | 1994 | 1995 | 1996 | 1997 | 1998 |
|---------------|-------|-------|-------|-------|-------|--------|
| BIS banks | 90 | 89 | 89 | 86 | 82 | 45 |
| (Total banks) | (151) | (150) | (150) | (150) | (149) | (148) |
| | 1999 | 2000 | 2001 | 2002 | 2003 | 2004 |
| BIS banks | 35 | 27 | 26 | 21 | 17 | n.a. |
| (Total banks) | (144) | (145) | (141) | (138) | (134) | (n.a.) |

Source: Japanese Bankers Association, *Zenkoku Ginkou Zaimushyohyou Bunseki* [Analysis of Financial Statements of All Banks], 1993-2003

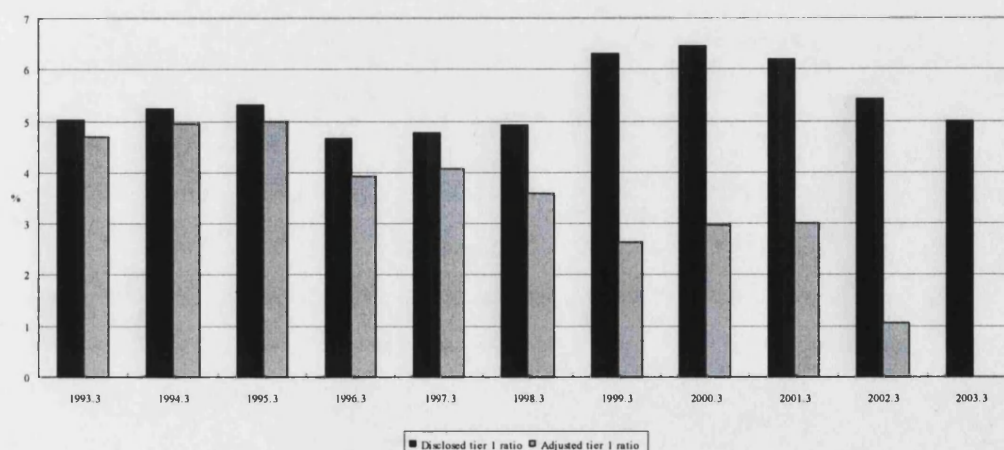
Disclosed BIS CARs of Japanese banks were also artificially inflated, as accounting standards that affected the BIS CAR calculation were lenient.³¹ Firstly, the rules of asset classification and loan loss provisioning were so lax that the regulatory capital of Japanese banks increased.³² Assuming that all non-performing loans in Japanese banks were provisioned, their tier 1 capital could have been extinct by 2002.³³ Secondly, the regulatory authority altered several accounting standards in order to help banks maintain

their BIS CARs above the minimum 8 per cent. For instance, banks were permitted not to record their unrealised losses on securities holdings,³⁴ while they were allowed to count 45 per cent of unrealised gains on land holdings as tier 2 capital. Thirdly, the regulatory authority lowered risk weights for certain assets. Fourthly, the banks were allowed to include deferred tax assets (DTAs) in tier 1 capital from fiscal year 1998,³⁵ even though DTAs lacked the prime characteristic of bank capital, that is, the availability to meet losses in the event of bank failure.³⁶ DTAs accounted for more than half the tier 1 capital of major Japanese banks in March 2003.³⁷ Finally, a large part of Japanese banks' capital was composed of public funds injected into the banks from 1998. In a strict sense, the public funds were not a reliable capital base, as they were debts that had to be paid back to the government.³⁸

In Figure 1, I estimated the actual tier 1 capital condition of major Japanese banks from March 1993 to March 2003 by deducting tax effects—including DTAs—and public funds from the tier 1 capital. The banks' disclosed tier 1 ratio was well beyond the required minimum of 4 per cent during the period. However, the quality of the tier 1 capital rapidly deteriorated due to an increase in the weaker capital elements from the late 1990s. The adjusted tier 1 ratio dropped to zero per cent in March 2003. Given that this estimation did not take into account other problems related to the banks' regulatory capital—such as under-provisioning—their actual capital condition was likely to be far worse than the adjusted tier 1 ratio shows.

Figure 1. The adjusted tier 1 capital ratios of major Japanese banks

(end of period; %)



Source: own elaboration based on data (personally-obtained) from Fitch Ratings

Note: the number of major banks varies according to year

Limitations of external compliance pressure

The record of Japanese banks on compliance with the BIS standard shows that external compliance pressure was not effective in ensuring that they adopt the BIS standard or maintain actual capital soundness. This section explains why foreign bank regulatory authorities and markets could not provide a strong incentive for the Japanese bank regulatory authority and Japanese banks themselves to comply with the BIS standard in substance.

Compliance pressure from foreign regulators

Bank regulatory authorities in G-10 countries could, to some extent, enforce Japanese banks to comply with the BIS standard, relying on their power to close their markets to Japanese banks. This form of enforcement of compliance lowered the costs to the regulatory authorities of enforcing foreign banks' compliance with the BIS standard as the *de jure* scope of the enforcement was limited to the authorities' own jurisdiction. In addition, it had the merit of imposing sanctions directly on the regulatory targets. In fact, even though the number of Japanese banks that were required to comply with the BIS standard under the Japanese regulations was limited to about 50 in March 1993, in practice, 91 banks opted to adopt the BIS standard. Most of the banks that voluntarily complied with it did so in preparation for their future advance into foreign markets.³⁹

However, the compliance pressure from capital regulations in foreign countries could materialise fundamentally for a limited portion of Japanese banks, that is, those with overseas establishments. Accordingly, the compliance pressure could not restrain the banks from abandoning the BIS standard. As the PCA system was implemented, and the risk of domestic regulatory punishment for non-compliance with the BIS standard increased as a result, Japanese banks began to withdraw rapidly from overseas operations and switch to the domestic capital standard, for which the required minimum CAR was only 4 per cent. In March 2003, 15 Japanese banks had overseas branches, and, reflecting this, only 17 out of a total of 134 Japanese banks adhered to the BIS standard at that time.

Meanwhile, although it was not a secret that the Japanese calculation method for the BIS CAR was lenient, foreign bank regulatory authorities were reluctant to put direct pressure on their Japanese counterparts to strengthen the Japanese BIS standard, or on

Japanese banks to improve their actual capital adequacy.⁴⁰ In fact, the Japanese accounting standards that artificially inflated the disclosed BIS CARs of the banks were not explicitly addressed by the Basle Accord, or manifested as controversial cases to be regarded as breaches of the Accord.

Although the Japanese rules on asset classification and the required levels of provisions were lax from the perspective of prudential regulation, they were not part of the areas that the Accord covered. The accounting change that allowed banks not to record their unrealised losses on securities holdings was not in breach of the Accord, because the Accord did not enforce the employment of mark-to-market accounting. The inclusion of unrealised gains on land holdings in tier 2 capital was explicitly allowed in the Accord, even though this practice was in conflict with the accounting standard for unrealised losses on securities holdings. The Japanese defended the inclusion of DTAs in regulatory capital by arguing that the practice was reasonable since Japanese tax rules were extremely strict (*vis-à-vis* US rules): Japanese tax authorities seldom allowed banks to deduct the amount of would-be uncollectible loans from their pretax income as an expense.⁴¹

In addition, G-10 countries had established the so-called Basle Concordat in 1975, which was revised in 1982 and in 1992. The Concordat established the principle of home country supervision of the solvency of foreign branches of banks.⁴² Therefore, it was the responsibility of the Japanese regulatory authority to supervise the capital adequacy of Japanese banks operating in foreign countries through their branches in those countries. Given no explicit violation of the Accord and the principle of home country supervision, the political costs to foreign regulatory authorities of pressuring their Japanese counterparts to strengthen the Japanese BIS standard, or of forcing Japanese banks to improve their actual capital adequacy, were high.

Finally, it is also worth noting that the incentive for foreign regulatory authorities to strengthen the Japanese BIS standard might not have been high. It was widely pointed out that an underlying reason for establishing the Accord was the hope of US and European banks to curb the international expansion of Japanese banks.⁴³ This objective was achieved, perhaps more drastically than expected, when the presence of Japanese banks in international markets shrank rapidly during the 1990s. While nine of the world's top 10 banks in terms of asset size were Japanese in 1989, that number dropped to two by 2001.

The Basle Accord was criticised by financial practitioners and academics for its failure to incorporate key insights of the theory of finance from the outset.⁴⁴ Its risk measurement framework did not generate a capital advantage for banks with well-diversified portfolios. Its system of five risk-weight categories was crude. The 8 per cent minimum CAR and the different risk weights for OECD and non-OECD countries were arbitrary. In addition, innovation by financial markets, in some cases with the intention of circumventing the BIS-standard regulation, eroded the Accord's effectiveness further.⁴⁵ In developing the analysis of market participants' view on the BIS standard, I focus on how the three major credit rating companies (CRCs)—Moody's Investors Service, Standard & Poor's, and Fitch Ratings—incorporated banks' BIS CARs in rating them. This analytical shortcut may be appropriate given that market participants examine the credit ratings of their investment targets, and, therefore, banks' credit ratings affect their cost of borrowing in markets.⁴⁶

The BIS standard was not accepted by the CRCs as a reliable solvency regulation, and, accordingly, the CRCs did not consider the BIS CAR a dependable solvency indicator. They did examine BIS CARs of banks, and frequently referred to them when altering the banks' credit ratings; however, after examining banks' BIS CARs, they adjusted them to calculate the *economic* capital ratios by taking into account various factors.⁴⁷ It was these capital ratios that influenced the CRCs' rating decisions. In addition, for the CRCs, the appropriate levels of capital that banks needed to hold differed according to their risk profiles.⁴⁸

Moody's Investors Service commented:

One common misconception is that the higher the level of capital the stronger the bank, regulatory solvency being considered as the defining factor for bank safety. This however is an analytical shortcut that most often leads nowhere and in fact has repeatedly proved to be wrong.... Stated differently, Moody's sees no automatic correlation between a bank's level of regulatory capital and its credit ratings.⁴⁹

Moody's also said: 'Regulatory capital ratios give a very imprecise indication of capital strength. This is so even when regulatory capital ratios are based on risk-weighted models, such as *the Basle criteria*'.⁵⁰ An analyst at Standard & Poor's commented: 'Standard & Poor's did not [penalise banks that did not adopt the BIS standard]. Rather,

Standard & Poor's relies on its own assessment of the appropriate level of capital it considers a bank would require given the bank's risk profile'.⁵¹ Fitch Ratings also published a report showing that there was no correlation between BIS CAR and credit rating.⁵² Indeed, even though Daiwa Bank, a major Japanese bank, switched to the domestic capital standard, resigning the BIS standard in March 2000, its Standard and Poor's credit rating did not change, staying stable at BB+ from December 1998 to September 2001.

The CRCs, to some extent, put pressure on banks to improve their actual capital quality. In general, they put more weight on tier 1 capital *vis-à-vis* tier 2 capital in assessing the creditworthiness of banks. Also, a huge proportion of DTAs in the tier 1 capital of Japanese banks had negative effects on their credit ratings.⁵³ However, the pressure from the CRCs on the banks to strengthen their actual capital adequacy was not effective because they also took into account a number of other factors when rating the banks. A rise in a bank's insolvency risk caused by one factor could be compensated for by a decrease in the risk due to other factors. For instance, the injection of public funds, which were perceived as a weak capital component by the CRCs themselves, to Japanese banks did have a positive effect on their credit ratings. The long-term ratings of Moody's Investors Service and Standard & Poor's for major Japanese banks, on average, rose or remained stable after the injection of a massive amount of public funds in April 1999, despite continuing deterioration of the banks' capital quality.⁵⁴ Also, of note is the fact that a Japan premium, which Japanese bank used to pay for interbank borrowing during the mid-1990s, virtually disappeared after the injection of the public funds.⁵⁵

The only area in which the CRCs played a role regarding compliance of Japanese banks with the BIS standard was that involving formal compliance of those that had already been regulated by the BIS standard. Although the BIS CAR was not a reliable solvency indicator, the CRCs emphasised that it was important for a bank to meet the regulatory minimum CAR requirement. A bank's failure to comply could be punished by the regulatory authority, and this could have negative consequences for the bank's investors and general creditors.⁵⁶ Thus, the CRCs could provide an incentive for banks regulated by the BIS standard to meet the required 8 per cent minimum. However, this compliance pressure from the CRCs on the banks was a reflection of domestic regulation. As a result, only a very limited number of Japanese banks faced this additional pressure from the CRCs to formally comply with the BIS standard during the late 1990s and early 2000s, as most of them were not adopting the standard.

Regulatory forbearance

After all, it was the Japanese regulatory authority that could compel Japanese banks to comply with the BIS standard in earnest. However, as discussed earlier, the regulatory authority aggressively exercised regulatory forbearance. This practice during the late 1990s and early 2000s is particularly intriguing because by that time many of the problems that had hindered the regulatory authority in carrying out strict regulation of the banking sector had been rectified, or had at least begun to be resolved. The Financial Supervisory Agency, the new bank regulatory authority, was established in June 1998 and was reorganised to become the Financial Services Agency (FSA) in July 2000.⁵⁷ Although the FSA inherited a large number of staff from the previous regulatory authority, the Ministry of Finance (MoF), the traditional strong informal network between bank regulators and banks virtually disappeared after the establishment of the new regulatory authority.⁵⁸ In addition, the official financial safety net developed significantly, and, as a result, there was a low likelihood that the failure of a bank to comply with the capital adequacy rules would trigger a systemic financial crisis.⁵⁹ However, new factors emerged to hinder the regulatory authority in implementing the BIS standard in earnest during the late 1990s and early 2000s: the diffusion of the compliance costs of the BIS standard from banks to small and medium-sized enterprises (SMEs), and the politicisation of banking regulation.

The diffusion of compliance costs

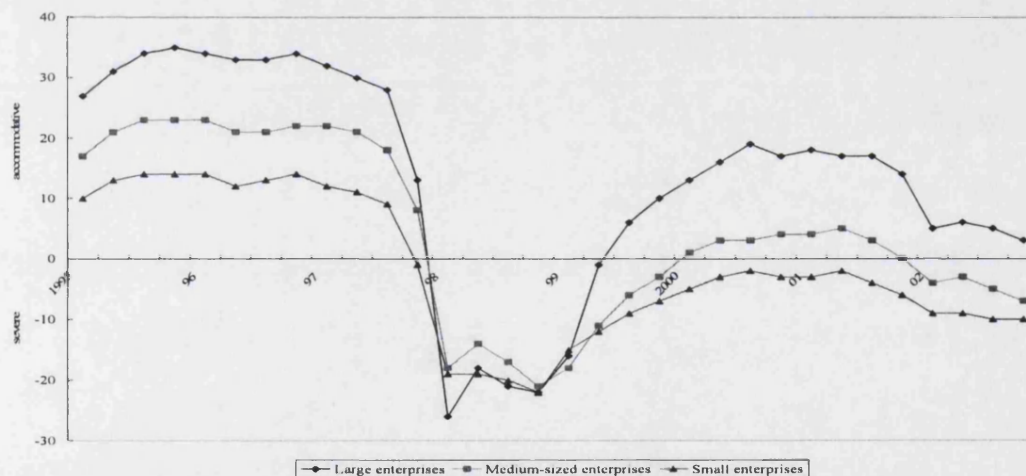
Until the implementation of a PCA system, the Japanese regulatory authority had discretion in taking regulatory action against banks that failed to meet the required minimum capital ratios, either BIS or domestic, and, in practice, they merely suggested that those banks should raise their CARs.⁶⁰ However, the introduction of a PCA system in April 1998 changed the 'rules of the game' in Japanese capital adequacy regulation. Under the PCA system, the regulatory authority had to take punitive actions automatically against banks when their CARs fell below the regulatory minimum CARs. The regulatory penalties for compliance failure ranged from the improvement of management to the suspension of small or all business activities. Therefore, banks had to meet the regulatory minimum CARs at all costs in order to preserve their management when the PCA system took effect. One method of doing this was to switch

to the domestic capital adequacy standard, whose required minimum CAR was 4 per cent. However, most major banks had to comply with the BIS standard because they had overseas establishments. Yet, under the stagnant economy, their capital bases were sharply contracting while they were not able to raise new capital.

They responded to the changed circumstances by shrinking their risk-weighted assets to maintain their BIS CARs above the regulatory minimum of 8 per cent. A reduction in risk-weighted assets could be achieved, with the least effect on total bank assets, by curtailing loans, whose risk weight was the highest at 100 per cent.⁶¹ As a result, the economy suffered from a credit crunch during 1997-8 (see Figure 2).⁶² A number of firms went bankrupt, and the implementation of the PCA system was widely criticised as one of the main causes.⁶³

Figure 2. The lending attitude of Japanese financial institutions

(diffusion index, %)



Source: Bank of Japan, *Economic and Financial Data on CD-ROM*, 2003

In particular, SMEs were most harshly hit by the credit crunch, because they relied heavily on bank borrowing, whereas larger firms could rely on direct fundraising from capital markets.⁶⁴ The number of bankruptcies of SMEs rose sharply from around 14,700 in 1996 to some 16,300 in 1997, and 19,000 in 1998. Although the kind of severe credit crunch that occurred during 1997-8 did not recur, bank lending attitudes and the financial positions of SMEs remained tight during the early 2000s.⁶⁵ Despite the injection of public funds in 1998 and 1999, banks could not generate enough capacity to increase their lending, and bankruptcies among SMEs increased again in 2000 after a brief decline in 1999. Through the credit crunch mechanism, the costs of complying

with the BIS standard were diffused from banks to other sectors of the economy, particularly SMEs.

The politicisation of banking regulation

In the meantime, banking regulation became rapidly politicised from 1997-on. Politicians began to engage actively in banking policies as the deteriorating health of the banking system turned into a financial crisis in the autumn of 1997, following the failures of high-profile financial institutions.⁶⁶ The influence of politicians, especially those of the ruling Liberal Democratic Party (LDP), on the banking policy-making process remained strong during the late 1990s and the early 2000s, despite the creation of the new financial regulatory authority, the FSA.⁶⁷ In addition, the institutional framework of the FSA made it vulnerable to political pressure: the Minister for Financial Services, who was a member of the Cabinet and was answerable to the Diet (the legislature), had effective control over the operation of the FSA; meanwhile there was no board with outside members to whom the Commissioner, the chief executive of the FSA, could be accountable, and the FSA had no budgetary independence, being funded from the central government budget.⁶⁸

As the financial positions of SMEs deteriorated and their bankruptcies increased, the LDP began to make desperate efforts to protect them. SMEs were the major economic actors in the economy, accounting for more than 50 per cent of value-added generated by all corporations. Moreover, they were politically important actors, because the large number of SMEs made them potentially of great significance to the electoral process.⁶⁹ The number of workers they employed accounted for more than 60 per cent of total employees—that is, voters—in all industries. In addition, they were traditional political supporters of the LDP.⁷⁰ Indeed, it was indicated that the LDP subcommittee in charge of banking policies had a strong interest in protecting SMEs.⁷¹

In consequence, the LDP were opposed to policies to strengthen the regulations related to bank capital adequacy, while demanding regulatory forbearance in order to raise banks' regulatory CARs and thereby increase loans to SMEs, even though the bank regulatory authority and Opposition parties sometimes called for stricter regulation of banks.⁷² One important event was the establishment of the Financial Inspection Manual in April 1998. In its initial plan of December 1997, the bank regulatory authority was to adopt stronger rules of asset classification and loan loss provisioning. However, the final version of the manual was substantially attenuated in those areas due to opposition

from banks that warned of aggravation of the already-rampant credit crunch, and from the LDP that worried about this as well.⁷³ Also, the LDP influenced the regulatory authority to postpone the implementation of the PCA system for domestic banks for one year until April 1999 and to change accounting rules to raise banks' CARs.⁷⁴ In addition, inspections of banks by the regulatory authority were carried out in a way that did not affect lending to SMEs.⁷⁵

Another salient episode demonstrating the failure of the regulatory authority's efforts to strengthen the capital adequacy regulations due to political intervention was the Programme for Financial Revival (PFR) of October 2002. As Japan's economy remained stagnant over more than a decade, the FSA, the Bank of Japan (the central bank), and also a minority of the LDP perceived that the weak capital position of banks had a negative effect on the country's economic recovery. As a result, from the early 2000s, they began to argue aggressively that the Japanese BIS standard was too lenient,⁷⁶ and the FSA established the PFR to strengthen the soundness of Japanese banks. In an earlier version of the PFR, the FSA planned to implement stricter rules on bank capital adequacy, including limiting DTAs that could be counted as capital to only 10 per cent of tier 1 capital. However, banks, fearing potential government intervention in their management, severely resisted the plan and warned of an extensive credit crunch.⁷⁷ Concerns over this led the majority of the LDP to block the implementation of the plans.⁷⁸ As a result, the announced plans of the PFR were substantially eased so that SMEs were not affected by the PFR. Even then, most of the announced plans were not implemented.⁷⁹

One may question whether the LDP's opposition to strengthening the capital adequacy regulations was an attempt to protect banks rather than SMEs. Yet the LDP did employ measures against banks' interests in order to protect SMEs. The injection of public funds to major banks whose BIS CARs were over 8 per cent in 1998 and 1999 was a prominent example of these measures. Banks were initially fiercely opposed to the injection of public funds because they were afraid of government intervention in their management and of a decline in their market image.⁸⁰ However, the LDP-led government forced banks to accept public funds, even by strengthening loan loss provisioning rules and launching inspections of banks to pressure them to apply for public funds. Finally banks reluctantly applied for public funds, and they were required to increase loans to SMEs.⁸¹ Banks may have been benefited from lax capital adequacy regulations, but the major reason for the LDP to exercise regulatory forbearance toward banks was to increase loans to SMEs.

Conclusion

International regulatory regimes can be effective only when they achieve their objectives. Thus, for the study of compliance with a regulatory regime to have meaning for this critical issue of regime effectiveness, a close examination of the nature of the compliance—whether it is cosmetic or comprehensive—should be carried out. This article has cast serious doubt on the validity of compliance strategies based on external pressures in enhancing comprehensive compliance, by finding severe cosmetic compliance in a least-likely case of non-compliance in terms of the operation of external compliance pressures. This finding raises further questions about power in the global political economy. The underlying logic of enforcement and market-based compliance strategies is that states and markets have power to influence a nation's behaviour. Yet this article has drawn attention to limitations of that power by demonstrating that the Japanese government could manipulate the implementation of the Basle Accord, thereby responding to domestic opposition to comprehensive compliance with it.

Accordingly, this research has highlighted domestic politics as a key area for comprehending compliance problems. In particular, this study has shed light on the adverse effects of compliance on a non-target sector comprised of politically-important actors, and has pointed to this as a critical cause of compliance failure. Given that SMEs in most countries rely heavily on bank loans, and their employees account for a majority of voters, this finding is very likely to be useful in analysing other countries' compliance failures for the BIS standard, even more so for those whose capital markets are less developed than Japan's.⁸²

Of course, the significance of the finding will depend more generally on its applicability to other issue areas. Regulations in other financial sectors are strong candidates to which the finding may be applicable, given that financial institutions are, in general, closely linked to other economic sectors. In this regard, it may be noteworthy that an International Monetary Fund report assessing the implementation of 12 international financial regulatory standards indicates 'public policy considerations' and low independence of regulatory agencies as factors that caused regulatory forbearance or impeded high levels of implementation.⁸³ Also, on closer examination, it may not be unusual to see that the cost to comply with environmental, health or labour regulations is not exclusively imposed on the regulatory targets. For instance, many environmental regulations affect not only regulated firms but also consumers, either indirectly, by

raising the prices of particular commodities, or directly, by banning them from using particular products or requiring them to use them in a particular way.⁸⁴ The analysis of non-compliance should pay attention to the broader domestic distributional effects of international regimes, going beyond focusing on the regulatory targets, in order to avoid missing important explanatory variables.

This article concludes by briefly suggesting one method to reduce compliance failures: the strengthening of the policy autonomy of regulatory authority from political influence. In fact, the favourable effect of the policy autonomy of regulatory authority on compliance with environmental or financial regimes has been often pointed out.⁸⁵ This research's finding that the Japanese regulatory authority failed to strengthen the Japanese BIS standard due to political pressures, despite their willingness, provides an additional support for the importance of strengthening measures to protect regulatory authorities from political intervention. Certainly the strengthening of their policy autonomy should be accompanied by measures for holding them accountable for the discharge of their actions.

Note

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1. Note that the real targets of a growing number of regulatory regimes in areas such as accounting, environment, finance, health and labour are private firms, although the majority of such regimes were established by national governments. See Tanja Börzel, 'Private Actors on the Rise? The Role of Non-State Actors in Compliance with International Institutions', July 2000, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=267733 (accessed 20 February 2002), pp. 2-3.
2. Jonas Tallberg argues that enforcement and management are more effective when combined. See Jonas Tallberg, 'Paths to Compliance: Enforcement, Management, and the European Union', *International Organization*, Vol. 56, No. 3 (2002), pp. 609-43.
3. There are a few studies that highlight domestic politics in explaining compliance. Yet, most of those studies either stress that the existence of domestic advocates for international regimes is important for the compliance, or focus on analysing how domestic support for international regimes arises. See, for example, Arild Underdal & Kenneth Hanf (eds), *International Environmental Agreements and Domestic Politics: The Case of Acid Rain* (Ashgate, 2000); Jeffrey T. Checkel, 'Why Comply? Social Learning and European Identity Change', *International Organization*, Vol. 55, No. 3 (2001), pp. 553-88; and Xinyuan Dai, 'Why Comply? The Domestic Constituency Mechanism', *International Organization*, Vol. 59, No. 2 (2005), pp. 363-98.
4. The narrow conceptualisation of compliance/non-compliance was suggested by Oran R. Young in his groundbreaking research on compliance with international public authority. See Oran R. Young, *Compliance and Public Authority: A Theory with International*

- Applications (Johns Hopkins Press, 1979), p 3.
5. A notable exception that addresses compliance in a broader sense is Edith Brown Weiss & Harold K. Jacobson (eds), *Engaging Countries: Strengthening Compliance with International Environmental Accords* (The MIT Press, 1998).
 6. See Weiss & Jacobson (eds), *Engaging Countries*; Andrew Walter, 'Implementation in East Asia', in Benu Schneider (eds), *The Road to International Financial Stability: Are Key Financial Standards the Answer?* (Palgrave, 2003), pp. 110-41; and International Monetary Fund, 'Financial Sector Regulation: Issues and Gaps', 4 August 2004, <http://www.imf.org/external/np/mfd/2004/eng/080404.pdf> (accessed 20 August 2005).
 7. The 1988 Basle Accord was amended in 1996 to cover market risks, and it will be replaced by the new capital adequacy framework, which is commonly known as Basle II, from 2006.
 8. Indeed, much research argues that compliance with the BIS standard has been high globally. See Charles K. Whitehead 'What's Your Sign?: International Norms, Signals, and Compliance', 1 August 2005, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=777684 (accessed 7 August 2005), p. 39.
 9. Beth A. Simmons, 'The International Politics of Harmonization: The Case of Capital Market Regulation', *International Organization*, Vol. 55, No. 3 (2001), pp. 601-2.
 10. See Financial Stability Forum, 'Report of the Follow-Up Group on Incentives to Foster Implementation of Standards,' 31 August 2000, http://www.fsforum.org/publications/publication_22_10.html (accessed 12 August 2002), p. 20.
 11. See 'Japanese efforts to grow in US said to be hindered back home', *The American Banker*, 12 March 1987; Ethan B. Kapstein, *Governing the Global Economy: International Finance and the State* (Harvard University Press, 1994); and Thomas Oatley & Robert Nabors, 'Redistributive Cooperation: Market Failure, Wealth Transfer, and the Basle Accord', *International Organization*, Vol. 52, No. 1 (1998), pp. 35-54. Kentaro Tamura argues that Japan's bank regulatory authority used this foreign pressure in order to strengthen the country's bank capital regulations. See Kentaro Tamura, 'A Regulator's Dilemma and Two-level Games: Japan in the Politics of International Banking Regulation', *Social Science Japan Journal*, Vol. 6, No. 2 (2003), pp. 221-40.
 12. See Joe Peek & Eric S. Rosengren, 'Determinants of the Japan Premium: Actions Speak Louder than Words', *Journal of International Economics*, Vol. 53 (2001), pp. 285-305. The Japan premium was a premium paid for interbank borrowing by Japanese banks relative to their major competitors in the US and Europe.
 13. See, for example, Kenneth A. Oye (eds), *Cooperation Under Anarchy* (Princeton University Press, 1986); George W. Downs, David M. Rocke & Peter N. Barsoom, 'Is the Good New about Compliance Good New about Cooperation?' *International Organization*, Vol. 50, No. 3 (1996), pp. 379-406; and A. Walter Dorn & Andrew Fulton, 'Securing Compliance with Disarmament Treaties: Carrots, Sticks, and the Case of North Korea', *Global Governance*, Vol. 3, No. 1 (1997), pp. 17-40.
 14. Arthur A. Stein, 'Coordination and Collaboration: Regimes in an Anarchic World', *International Organization*, Vol. 36, No. 2 (1982), pp. 299-324.
 15. Downs, Rocke & Barsoom, 'Is the Good New about Compliance Good New about Cooperation?', pp. 386.
 16. See Robert Axelrod & Robert O. Keohane, 'Achieving Cooperation Under Anarchy: Strategies and Institutions', in Oye (eds), *Cooperation Under Anarchy* (Princeton University Press, 1986), pp. 235-6.
 17. See, for example, Kapstein, *Governing the Global Economy*; and Oatley & Nabors, 'Redistributive Cooperation'. See also Simmons, 'The International Politics of Harmonization'.
 18. See, for example, Financial Stability Forum, 'Report of the Follow-Up Group on Incentives to Foster Implementation of Standards'; and Financial Stability Forum, 'Final Report of the Follow-Up Group on Incentives to Foster Implementation of Standards', 21 August 2001, <http://www.fsforum.org/Reports/Incentives.pdf> (accessed 12 August 2002). See also *infra* note 21.
 19. Simmons, 'The International Politics of Harmonization', p. 602.

20. See Susmita Dasgupta, Benoit Laplante & Nlandu Mamingi, *Capital Market Responses to Environmental Performance in Developing Countries*, Policy Research Working Paper (No. 1909), The World Bank Development Research Group, Washington, D.C.
21. Bank for International Settlements, *Report on International Developments in Banking Supervision*, (Report No. 8), Basle, p. 20; Simmons, 'The International Politics of Harmonization', pp. 601-5; Daniel E. Ho, 'Compliance and International Soft Law: Why Do Countries Implement the Basle Accord?', *Journal of International Economic Law*, Vol. 5, No. 3 (2002), pp. 647-88; and David A. Singer 'Capital Rules: The Domestic Politics of International Regulatory Harmonization', *International Organization*, Vol. 58, No. 3 (2004), p. 563.
22. See, for example, Abram Chayes & Antonia Handler Chayes, 'On Compliance', *International Organization*, Vol. 47, No. 2 (1993), pp. 175-205; Abram Chayes & Antonia Handler Chayes, *The New Sovereignty: Compliance with International Regulatory Agreements* (Harvard University Press, 1995); and Abram Chayes, Antonia Handler Chayes & Ronald B. Mitchell, 'Managing Compliance: A Comparative Perspective', in Weiss & Jacobson (eds), *Engaging Countries*, pp. 39-62.
23. Chayes & Chayes, *The New Sovereignty*, p. 32.
24. Chayes & Chayes, 'On Compliance', p. 176.
25. *Ibid.*, pp. 187-97.
26. Chayes & Chayes, *The New Sovereignty*.
27. The problem of ambiguity and indeterminacy of rules is a general characteristic of a number of international regimes. See Chayes & Chayes, 'On Compliance', pp. 188-92.
28. See David Vogel & Timothy Kessler, 'How Compliance Happens and Doesn't Happen Domestically', in Weiss & Jacobson (eds), *Engaging Countries*, pp. 19-37.
29. Although the Japanese regulatory authority did exercise forbearance in regulating banks during the pre-PCA period, the regulatory forbearance was not directly related to the capital adequacy regulations.
30. Author interview with Hitoshi Horikawa (Deputy Director of the Supervisory Bureau, Financial Services Agency), Tokyo, 2 April 2004.
31. Due to space constraints, this article does not fully explain the mechanisms by which the accounting standards inflated disclosed BIS CARs of Japanese banks. For an understanding of the mechanisms, see references.
32. See Mitsuhiro Fukao, 'Financial Sector Profitability and Double-Gearing', in Magus Blomstrom et al. (eds), *Structural Impediments to Growth in Japan* (The University of Chicago Press, 2003), pp. 9-35; and International Monetary Fund, *Japan: Financial System Stability Assessment and Supplementary Information, Country Report* (No. 03/287), Washington, D.C., p. 19.
33. See 'Japan battling to hold off implosion', *The Banker*, July 2002.
34. The practice ended when mark-to-market accounting was introduced in fiscal year 2001.
35. DTAs were credits against taxes on future taxable income.
36. See International Monetary Fund, *Japan*, p. 18; and Mitsuhiro Fukao, 'Weakening Market and Regulatory Discipline in Japanese Financial System', paper presented to the conference, *Market Discipline: The Evidence across Countries and Industries*, cosponsored by the Bank for International Settlements and the Federal Reserve Bank of Chicago, Chicago, IL., 30 October - 1 November 2003, pp. 17-18.
37. Cabinet Office, *Keizai Zaimu Hakshyo: Kaikaku Nakushite Seichyomo Nashi III* [Annual Report on the Japanese Economy and Public Finance: No Gains Without Reforms III] (Cabinet Office, Government of Japan, 2003), p. 110.
38. See 'Equity: the banks say they have healthy amounts of capital', *Asahi Shimbun*. 12 October 2002.
39. 'Most regional banks opt for BIS capital ratio', *Jiji Press*, 15 February 1989.
40. Author interview with Takatoshi Ito (Deputy Vice Minister for International Affairs, Ministry of Finance, 1999-2001), Tokyo, 1 March 2004.
41. 'Takenaka cedes deferred tax plan', *The Nikkei Weekly*, 5 November 2002.
42. For the supervision of the capital adequacy of foreign banks in major countries, see Michael Gruson & Ralph Reisner (eds), *Regulation of Foreign Banks: United States and*

- International (LEXIS Publishing, 2000).
43. See Kapstein, *Governing the Global Economy*; and Oatley & Nabors, 'Redistributive Cooperation'.
 44. 'Review loan risk weighting rules under accords, supervisors urged', Thomson's International Banking Regulator, 25 October 1991; and Cem Karacadag & Michael W. Taylor, *The New Capital Adequacy Framework: Institutional Constraints and Incentive Structures*, IMF Working Paper (WP/00/93), International Monetary Fund, Washington, D.C., p. 5.
 45. Karacadag & Taylor, *ibid*, pp. 5-7.
 46. See Japan Center for International Finance, 'Characteristics and Appraisal of Major Rating Companies', 1999, 2001, <http://www.jcif.or.jp/e/report/rating.html> (accessed 13 December 2003); and Japan Center for International Finance, 'Characteristics and Appraisal of Major Rating Agencies', 2000, <http://www.jcif.or.jp/e/report/rating.html> (accessed 13 December 2003). According to an estimate, an 'AAA' bank could issue debt offering interest of between 0.1 and 0.6 per cent less than an 'AA' bank. See 'Banks owe a debt to the exclusive AAA club', *The Times*, 5 March 1991.
 47. There is no official definition of economic capital, but the underlying logic is that a bank's true economic capital should be permanent and readily available to compensate for massive losses before general creditors would be affected in any way. See Moody's Investors Service, 'Rating Methodology: Bank Credit Risk (An Analytical Framework for Banks in Developed Markets)', April 1999, http://www.moody.com/moodys/cust/research/venus/Publication/Rating%20Methodology/noncategorized_number/44246.pdf (accessed 1 October 2003), p. 37.
 48. The three major CRCs' bank ratings methodologies are available from their websites: <http://www.fitchratings.com>, <http://www.moody.com>, and <http://www2.standardandpoors.com>.
 49. Moody's Investors Service, 'Rating Methodology', p. 36.
 50. Moody's Investors Service, 'Rating Methodology: Bank Credit Risk in Emerging Markets (An Analytical Framework)', July 1999, <http://www.moody.com/moodys/cust/research/MDCdocs/18/2000400000301534.pdf> (accessed 1 October 2003), p. 32. Emphasis added.
 51. Author interview with an analyst at Standard & Poor's, email correspondence, 11 August 2004.
 52. Fitch Ratings, 'Are Credit Ratings Correlated With Regulatory Capital?' 26 November 2003, http://www.fitchratings.com/corporate/reports/report.cfm?rpt_id=190744§or_flag=3&marketsector=1&detail= (accessed 19 June 2004).
 53. See 'Fitch downgrades Japanese banks', *FT Investor*, 30 January 2003; 'Moody's to review ratings of 4 banks for possible downgrades', *Japan Economic Newswire*, 12 June 2003; and Fitch Ratings, 'Most Major Japanese Bank Ratings Lowered due to Weakening Financial Condition & Declining Sovereign Rating', 2003, <http://www.fitchratings.com> (accessed 2 January 2004).
 54. See Japan Center for International Finance, 'Characteristics and Appraisal of Major Rating Companies', 2001, pp. 9-10.
 55. Takatoshi Ito & Kimie Harada, *Market Evaluations of Banking Fragility in Japan: Japan Premium, Stock Prices, and Credit Derivatives*, NBER Working Paper (No. 9589), National Bureau of Economic Research, Cambridge, MA. On the Japan premium, see *supra* note 12.
 56. Moody's Investors Service, 'Rating Methodology: Bank Credit Risk (An Analytical Framework for Banks in Developed Markets)', p. 37.
 57. The Financial Restructuring Commission also operated from December 1998 to January 2001 as a temporary body to deal with failed financial institutions.
 58. Jennifer Amyx, 'A New Face for Japanese Finance?: Assessing the Impact of Recent Reforms', in Gil Latz & Koide Izumi (eds), *Challenges for Japan: Democracy, Finance, International Relations, Gender* (The International House of Japan, 2003), pp. 50-2; and International Monetary Fund, *Japan*, p. 76. Indeed, some Japanese scholars pointed out the lack of communication between the new regulatory authority and banks as a new problem hindering effective banking supervision (author interview with Shinsaku Iwahara (professor,

- University of Tokyo), Tokyo, 26 January 2004). On the informal network between the MoF and banks (namely, amakudari, mofutan, or ama-agari) and its effects on the Japanese banking regulation, see Jennifer A. Amyx, 'The Banking Crisis in Japan: Policy Paralysis in the Network State', paper presented to the 44th Annual Convention of International Studies Association, Portland, O.R., 25 February - 1 March 2003; and Adrian Van Rixtel, *Informality and Monetary Policy in Japan: Political Economy of Bank Performance* (Cambridge University Press, 2002).
59. See Deposit Insurance Corporation of Japan, 'Outline of Funding Program for FY2003 by Account', http://www.dic.go.jp/english/e_katsudou/e_katsudou6-2.pdf (accessed 22 March 2004); and Tim Callen & Martin Muhleisen, 'Current Issues Facing the Financial Sector', in Tim Callen & Jonathan D. Ostry (eds), *Japan's Lost Decade: Policies for Economic Survival* (International Monetary Fund, 2003), p. 33.
 60. Author interview with Yoshimasa Nishimura (former Director-General of Banking Bureau, Ministry of Finance, 1994-6), Tokyo, 5 March 2004.
 61. See David Woo, In Search of "Capital Crunch": Supply Factors Behind the Slowdown in Japan, IMF Working Paper (WP/99/3), International Monetary Fund, Washington, D.C., p. 8.
 62. Ibid.
 63. 'Gov't to ease new banking supervision rules', Japan Economic Newswire, 22 December 1997.
 64. The ratio of bank debt to total debt for SMEs was over 80 per cent. See Giovannit Dell'Ariceia, 'Banks and Credit in Japan', in Callen & Ostry, *Japan's Lost Decade*, p. 48.
 65. Cabinet Office, *Keizai Zaimu Hakshyo*, pp. 97-100.
 66. Until the financial crisis, the Japanese bank regulatory authority—the MoF—had, to a large extent, maintained independence from politicians. See Amyx, 'The Banking Crisis in Japan'.
 67. Furukawa Motohisa, 'The Financial Diet of 1998', in Gerald L. Curtis (eds), *Policymaking in Japan* (Japan Center for International Exchange, 2002), pp. 42-61; and Nemoto Takumi, 'The Successful Handling of the Financial Crisis', in Curtis (eds) *Policymaking in Japan*, pp. 18-41.
 68. International Monetary Fund, *Japan*, pp. 30, 37-8, 75-6.
 69. See Hugh T. Patrick & Thomas P. Rohlen, 'Small-Scale Family Enterprises', in Kozo Yamamura & Yasukichi Yasuba (eds), *The Political Economy of Japan, Volume I. The Domestic Transformation* (Stanford University Press, 1987), pp. 366-72.
 70. Gary D. Allison, 'Citizenship, Fragmentation, and the Negotiated Polity', in Gary D. Allison (eds), *Political Dynamics in Contemporary Japan* (Cornell University Press, 1993), p. 44; and T. J. Pempel, *Regime Shift: Comparative Dynamics of the Japanese Political Economy* (Cornell University Press, 1998), p. 165.
 71. Confidential author interview with a senior official of the Bank of Japan, Tokyo, 20 February 2004.
 72. The dominance by the coalition of Opposition parties in the Upper House during mid-1998 made for a few progressive measures in banking regulation.
 73. Author interview with Shinsaku Iwahara (Chair of the Work Group on Financial Inspection Manual), Tokyo, 16 February 2004.
 74. 'Lending squeeze vexes Japanese govt', *Asia Pulse*, 24 December 1997; and 'MoF to relax capital-adequacy rule for domestic banks', Japan Economic Newswire, 24 December 1997.
 75. See Financial Services Agency, 'Shyuyoginni Taisuru Tokubetsu Kensano Kekkani Tsuite [Results of the Special Inspections on Major Banks]', 12 April 2002, <http://www.fsa.go.jp/news/newsj/13/ginkou/f-20020412-4.html> (accessed 5 February 2004).
 76. See 'Controversy builds over lenders' health', *The Nikkei Weekly*, 3 June 2002.
 77. For example, the President of Sumitomo Mitsui Banking Corporation (a major Japanese bank) told the Minister for Financial Services, Heizo Takenaka, in a meeting: 'If you're going to change the rules overnight, I'm afraid it's very likely there'll be an extensive credit crunch'. See 'Critics say Takenaka's plan won't rid banks of bad loans', *Asahi Shimbun*, 26 October 2002.
 78. The FSA postponed announcing the PFR, citing 'political reasons', after Minister Takenaka had a meeting with LDP members. See 'LDP members attack Koizumi strategy', *Financial Times*, 23 October 2002.

79. Author interview with Mitsuhiro Fukao (member of the Working Group on Banks' Capital Adequacy Ratios for the Programme for Financial Revival), Tokyo, 9 March 2004; and author interview with Yuri Okina (member of the Working Group), Tokyo, 24 March 2004.
80. 'Caution over Japanese funds scheme', *Financial Times*, 18 February 1998; and 'Gov't to step up warnings to banks to recapitalize', *Japan Economic Newswire*, 15 October 1998.
81. See 'Public funds to go to Tokyo-Mitsubishi', *Asahi Shimbun*, 14 January 1998; 'Financial stabilization plan inching ahead', *The Nikkei Weekly*, 23 February 1998; 'FSA to get tougher in evaluating LTCB', *Mainichi Daily News*, 16 October 1998; 'Tough love for banks', *Asiaweek*, 7 May 1999; Financial Restructuring Commission, 'The Viewpoint on the Write-offs and Allowances in Association with the Capital Injection', 25 January 1999, <http://www.fsa.go.jp/frc/newse/ne002.html> (accessed 10 December 2003); and Financial Restructuring Commission, 'Basic Viewpoints and Results of the Examination with Regard to the Capital Injection for the Applicant Banks', 12 March 1999, <http://www.fsa.go.jp/frc/newse/ne004a.html> (accessed 10 December 2003). The government also relaxed tough conditions on management responsibility and restructuring.
82. The International Monetary Fund recently reported that the BIS standard was loosely applied in a number of countries. See International Monetary Fund 'Financial Sector Regulation', p. 21.
83. *Ibid*, pp. 12, 21.
84. Vogel & Kessler, 'How Compliance Happens and Doesn't Happen Domestically', p.35.
85. See, for example, Harold. K. Jacobson & Edith Brown Weiss 'Assessing the Record and Designing Strategies to Engage Countries', in Weiss & Jacobson (eds) *Engaging Countries*, p. 553; and International Monetary Fund 'Financial Sector Regulation', p.12.