Framing measurement with management
Basel II as a new order of knowledge in international banking regulation
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ABSTRACT

This paper sheds light on changes in international banking regulation by focussing on the new regulatory standard (Basel II) in detail. From a sociological systems-theoretical perspective and on the basis of a hermeneutic analysis it will be shown how far the framework wants the supervisors not only to concentrate on financial aspects of the bank but also to focus on the bank as a formal organization. Therefore, further organizational processes and the management of the bank become relevant for the regulatory practices which require new forms of supervisory knowledge. Comparing Basel II with the proceeding framework (Basel I) it becomes clear that dealing with organizational facets in such an explicit way, means that there has been a change of paradigm in global banking supervision.

Keywords: Governance, Systems Theory, Objective hermeneutics, Banking regulation, Basel II

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Introduction

Recent debates in governance studies and economic sociology have highlighted the significance of counting and calculation in the political regulation of social phenomena (e.g. Power 2004; Vollmer 2003). In several approaches, an invasion of these practices in many social fields is observed, a (second) “avalanche of printed numbers” (Hacking 1982) that serve as techniques for representations and regulation of social processes. Measurement and quantification – this is the idea of these studies – are the ways of knowing as well as ways of steering societal reality to a great extent.

In this paper, I would like to focus on the regulation of one social field, which is influenced and dominated by numbers and quantities like nearly no other societal sphere: the international banking system. In this respect, I will show that even in this number-based context a shift from solely looking on financial numbers to a complementary perspective is observed, which focuses on people, processes and systems in a different form. By doing so, I will refer to the most important regulatory standards in international banking supervision that have been published till now: the two Basel Accords, known as Basel I and Basel II.

Indeed, the importance and effectiveness of international banking regulation are broadly discussed in international political economy and in approaches on global governance as well (e.g. Cerny 1994; Kapstein 1996; Wood 2005). But the concrete content and form of regulation, the way in which banks and the banking system are observed by the supervisors have not been analyzed in a systematic way. There are some contributions, which describe the rise of new, so called ‘qualitative’ forms of banking regulation with regard to the Basel initiatives (Reinicke 1998, 126; Strulik 2006). These studies describe the different forms of regulation but do this without analyzing how far form and content of regulation are connected in a specific way. This will be the main interest in this paper. I will try to show why so called ‘qualitative’ forms of regulation can be considered as functional for effective banking regulation.

By doing this I will use a systems-theoretical perspective that allows a distinction between functional/societal systems and organization systems.[1] While the financial system, and the banking system as its subsystem, are social systems that follow only one rationality, the logic of investment and the language of capital (Willke 2007), bank organizations have to obey

[1] When I speak of systems-theory, I refer to the sociological approach, elaborated by Niklas Luhmann (Luhmann 1995).

different factors. Although they primarily make decisions with regard to the financial logic they also refer to further contexts such as the scientific, technical, legal and political. This becomes obvious on a more general level. If one observes the bank as a formal organization comparable with enterprises or hospitals it is clear that banks do not only consist of credit positions, flows of money and balances. But the stability and reproduction of banking organizations depends on people with specific competences, technological infrastructure, as well as on legal know-how and stable relations with its environments like the public or the political system.[2] I will argue that the broadening of the perspective brings new forms of supervision, new ways of knowing how banks operate, and an understanding of how the banking system is supervised by the political system with it.

Looking at the history of banking regulation, it becomes clear that it is a history of "trust in numbers" to a great extent.[3] It is a history of focussing on financial indicators and on the measurement of so called "credit risks" and "market risks". The established national rules on banking regulation are not alone in referring to these aspects. The first Basel Accord is – as I will show – dominated by a narrow focus on the financial system and a quantitative, calculative logic of supervision. On the one hand, Basel II is not the end of (this) history. It even stresses the importance of genuine financial risks and the quantitative calculation of expected risk. It provides new elaborated models of risk-management on a stochastic base. But on the other hand, Basel II goes beyond this narrow focus and logic of regulation. It focuses on the organization as a formal organisation, scanning non-financial aspects that could become relevant for effective forms of regulation. In consequence, the second Basel Accord provides new forms of supervisory knowledge and supervisory practice.

In order to reconstruct this regulatory shift from capital and measurement to organization and management, I will compare some relevant passages of the two documents, Basel I and Basel II, in detail. In this context, it will be argued that each document creates a special order of knowledge[4] in banking regulation that sheds light on special aspects and darkens other possible topics. It can then be observed that there is a shift from a purely financial oriented to a broader approach entailing organizational aspects.

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[2] In this context, my argument is similar to classical organization/environment approaches in organization theory (e.g. Aldrich 1979; Thompson 1967)

[3] This is true for political regulation at all (meaning?). Authors like Theodore Porter (Porter 1995), Michel Foucault (Foucault 2004) and Ian Hacking (Hacking 1990) describe the historical evolution of a number and formula based view in political governance.

[4] In this context the analyses of Alfred Schütz might me instructive as they illustrate the arranging character of knowledge for social practices (Schütz 1971, 401f).

This paper is structured as follows: In the first part, I will show the rise of the global banking system and the political need for international forms of banking regulation. Secondly, the constitution of an international regime in global banking, the Basel Committee on Banking Supervision and its first initiatives will be described. Thirdly, I will present my methodological approach, which is used for the core analysis. After that I will present some findings and will provide some thoughts on what this could mean for analyzing international political regulation in general.

The globalization of international banking and challenges for political regulation

The credit business has long been a supranational business, as it already existed before the modern state system was established.[5] But with the rise of the modern state as a dominant political form and the rise of national currencies, banking business became embedded into the order of the nation state. Although the banking industry was an important condition for the establishment of the modern world economy, financial flows were limited and steered not only by the logic of capital but also by political decisions. This becomes obvious with regard to the Bretton Woods system, the economic order of the post-world-war-II era to the 1970s. In this era, the financial system was fragmented into nation states which brought destructive as well as productive effects with it. On the one hand, political decisions limited the dynamic and effectiveness of the financial system. On the other hand, financial crises could be buffered by capital controls imposed by national regulators.

The end of the Bretton Woods system was the starting point of a rather dynamic financial liberalization. Not only did the 1970s represent a central decade for significant changes in the banking business from a political standpoint, but innovations in information technology as well as in financial sciences evoked new dynamics in the financial system. The invention of the micro-computer and the constitution of global communication networks[6] brought about a certain loss in territoriality in the financial system (O'Brian 1992) and became a reality sui generis (Knorr Cetina 2002). The rise of new financial instruments such as derivatives might be an instructive example.

[5] There are many examples given in historical studies (e.g. De Rover 1974).
[6] For a description of these inventions and the social consequences see Manuell Castells (Castells 2003, 58).

These dynamics of the financial system generated a new level of complexity to the system, creating conditions for the financial system to become an autonomous social system that follows its own binary code (investment/not investment). These fundamental changes in the financial sphere not only initiated new opportunities for investment but also, signified a new quality of risk for the system at all (as a whole???). Reflecting on the dynamics and scope of banking panics in history, it becomes clear that the failure of a single bank can lead to fatal consequences for the banking sector in general. Such forms of risk are known as systemic risk. Both the emergence and the development of such risks are hard to predict and neither prevention nor an appropriate reaction to any crisis can be achieved.[7]

These risks can be generated by genuine financial risks like credit risks or market risks. They can emerge within the financial system and can spread across the globe. Furthermore they can emerge because of developments in the environment of the financial system. Natural disasters but also the failure of technical infrastructure within banks or in their environment might provoke irritations for global financial flows that can cause a serious destabilization of the financial system. In studies of risk management this forms of risk are categorized by the term operational risk.[8] One further aspect also underlines these phenomena: Not only has the financial system as a communication system been globalised since the 1970s but also, many banking organisations have become multinational or transnational institutions, following the enlargement of industrial enterprises in this period (Reinicke 1998, 13). In consequence, multinational banking organizations built complex environments for the global banking system like wide-ranged communication networks and complex internal organization structures. These (re-)forms of organization generated new economic benefits but also new challenges for organizational control.

As a consequence, these new quantitative and qualitative developments of risk in the banking sector generated new forms of political regulation as well. Indeed, political actors [Note: who are they??] did not rebuild political barriers and hesitated to undo globalization or to throw sand in the wheels of the financial system as some economists called (Eichengreen 1994). But a supranational regime was established which should stabilize the international banking

[7] Those systemic risks are characterized by no longer referring to single elements of labour division or mechanistic contexts but having consequences for the kind of systemic operations, as certain individual risks are bumping due to the integration of elements and lead to a system destabilization (Willke 2002, 30). For further details about system risk see Alexander 2006; Hellwig 1995.

[8] The importance of operational risk is underlined in the following publication: Piaz 2002, 37.

1. “by studying the international banking system, and developments in that system in the way of technology, innovation and national policies, and publishing papers on the committee’s findings
2. by maintaining surveillance of the international banking system and tracking problems as they develop;
3. by negotiating agreements between member states to increase cooperation and harmonization between national regulators, as well as eliminate gaps in the supervision of international banking system” (Wood 2005, 46).

The responsible organization of this regime, known as the “Basle Committee”[9], is (?) was located at the Bank of International Settlements in Basel, Switzerland. Its members were the national supervisory institutions of the G10 countries that met each other at the Bank of International Settlements continuously.

The Basle committee and its early publications

In 1975 the Basel Committee ratified its first official document that was known as the ‘Basel Concordat’.[10] In this publication the committee formulated the function of this paper, explicit-tly

> “The object of this report is to set out certain guidelines for co-operation between national authorities in the supervision of ‘banks’ foreign establishments and to suggest ways of improving its efficacy” (BCBS 1975, 1).

The term “guidelines” underlines the pretension of this first publication. It was not only elaborated to give information about the banking system, but to define specific rules with regard to international cooperation. The paper stressed the fact that there is no alternative and that international coordination in regulating international banks was necessary. Thus, it was the primary aim of the Basel Committee to elucidate that no institute could escape political banking regulation. The form of regulation, however, remained unspecific. The paper did not provide any specific rules on how to regulate a bank. Banking supervisors of nation states were asked to cooperate. But the base on which they had to work together was not mentioned

[9] In 1973 this institution was founded under the name: “Standing Committee on Banking Supervision on Banking Regulation and Supervisory Practices”. It was renamed in 1989.
[10] The full official name of the document was: Basel Committee: Report on the supervision of banks' foreign establishments – Concordat (BCBS 1975).

in the Basel Concordat in any way: what kind of knowledge would be relevant to supervise international banks effectively remained unresolved.

Thus, Ethan Kapstein describes the consequences of the Concordat as a “general education about how banks were supervised within member countries” (Kapstein 1996, 45). From his point of view, the rules of the nation states were too heterogeneous to find common and specific solutions for concrete practices or regulation. This form of attesting cooperation between the national supervisory institutions can be illustrated in different papers that were published later on. Reflecting on these procedures with regard to the three points, mentioned above, one can speak of corporation (meaning ?) without harmonization.

But this was only one pattern of publication. In addition, the committee published further papers which followed a different logic of argumentation. These papers gave detailed information about the measurement and treatment of special financial risk (e.g. BCBS 1978, BCBS, 1984 #796). Moreover they focus on organizational aspects like internal control systems in banks and the competences in banks. On an abstract level, it can be argued that these papers do not follow a political or legal logic in a narrow sense. They evaluate certain developments. They don’t prescribe binding rules but formulate options and possibilities. In sum, the publications of the Basel Committee are marked by two different logics. On the one hand, there are some that proclaim coordination and corporation but didn’t elaborate binding rules on which basis international corporations could function in detail. On the other hand there are papers in which the committee observes the banking system from a more science-based point of view. They give very detailed approaches for evaluating different forms of risks for single bank organizations as well as managing the distribution of risks between different subsidiaries of international banking groups. The ideas of the Basel Committee did not stand beyond but beside the law and in accordance with legal practices of the nation states.[11]

On the basis of these publications it will become clear why the two Basel frameworks are of special importance to the international banking regime. They formulate binding rules in detail. They provided certain knowledge about promising styles of banking regulation and created

[11] This defensive positioning of the Basel Committee is reflected in several publications, for example in the paper Authorisation procedures for banks' foreign establishments: “While fully recognising these differences in national laws and practices and the difficulties involved in legislation, the Committee believes that some common understandings about desirable general principles with regard to the granting of inward and outward authorisations would be beneficial” (BCBS 1983, 1).

common standards for regulatory practices in the nation states of the G10. They established possibilities of coordination *and* stabilization. But how did it become possible to install such frameworks on an international level although there was a lot of heterogeneity within the nation states? What were the conditions for implementation into the regulatory orders within the national states?

Analyzing regulatory efforts – the methodological approach

In order to find answers for the questions mentioned above, I focus on the two Basel frameworks in detail as I expect communicative structures within the text that might explain this shift in global banking regulation. In this context, I refer to a qualitative method of social sciences which is called "objective hermeneutics" or "structural hermeneutics" – a concept which is currently one the most prominent approaches in qualitative research in German-speaking countries" (Reichertz 2004). This qualitative method was mainly developed by Ulrich Oevermann in Frankfurt, Germany and was predominantly elaborated for educational research. Objective hermeneutics can be used to analyse social interaction but also other social facts like fictional and non-fictional texts, paintings, films and even landscapes (Oevermann 2005).

What is the central approach for this research method and what can be found within those social facts? In contrast to other hermeneutic methods, the intentions of speakers or authors do not matter. "The only thing" – as Jo Reichertz formulates it – "that counts is the objective meaning structure of the text in a particular linguistic and interactive community" (Reichertz 2004, 570). Thus I ask in which ways the texts of the two Basel frameworks can be understood. By doing this, it becomes possible to discover the latent meaning structures in specific social contexts that are based on collective shared knowledge within society respective in a specific social context.[12] [you need to explain this further /clarify – the language is quite confusing]

This meaning structure and the borders of this structure are not determined. Especially at the beginning of a social situation or text there might be a lot of ambiguity as to how the situation or the text develops further. Objective hermeneutics makes it possible to reconstruct how the text reduces contingency. This method is interested in showing how the text constitutes and

[12] This theoretical assumption is mainly influenced by the institutional theory of Berger and Luckmann (Berger 2003).

stabilizes itself by establishing an internal structure that is based on the expectations and culture schemata of its observer or reader. By using ‘objective hermeneutics‘, one tries to identify this structure by interpreting the text in many cases word after word.[13] The first sentences in particular are of great importance as one might expect that these passages manifest the structure for the following internal logic of the text. In what follws, it is of main interest to recognize if and how the text reproduces this logic. Making experiments of thought, one generates options on how the text could continue and compares potential phrase complements with the factual phrase complements.

With regard to my special research case, I intend to answer the question of how the texts constituted specific order of knowledge for the regulators that enabled new forms of coordination and harmonization. I am interested in finding out, what sort of rationality is hidden behind the regulatory rules, as presented in the two frameworks. In the next section, I will present some selected findings of this empirical work. Therefore, a few passages will be explained that might be characteristic for the specific orders of knowledge that are established by Basel I and Basel II.

Ways of measuring capital – the Basel Accord of 1988

The final document of the first Basel Accord was published in 1988 in Basel (BCBS 1988). In the relevant literature is considered to be a “landmark” in banking regulation (e.g. Wagster 1996). Or, as Ethan Kapstein refers to it as a

> „most significant step taken to date by bank supervisors in advancing policy convergence and creating an international banking regime, with formal principles, norms, rules, and decisionmaking procedures“ (Kapstein 1996. 118).

Our [Note: you move from I to We] purpose is to analyse how the Basel Accord was suited to become a standard that could cope with the heterogeneity of the supervisory practices in the nation states. It will be shown that this document follows a specific logic and rationality that may give an explanation for the status of the framework. The general approach of the

[13] In this context, it is common to analyze the texts in groups, in order to generate different possibilities of social meaning. I have to thank Kai Buchholz, Sascha Dickel, David Kaldewey, Marc Moelders and Janina Schirmer from the Institute of Science and Technology Studies, University of Bielefeld, who helped to interpret the material in numerous sessions.

document becomes obvious when we refer to the following passage in the introduction that evokes specific expectations in the addressee.

> "Two fundamental objectives lie at that heart of the committee's work on regulatory convergence. These are, firstly, that the new framework should serve to strengthen the soundness and stability of the international banking system; and, secondly, that the framework should be fair and have a high degree of consistency in its application to banks in different countries with a view to dimishing an existing source of competitive inequality among international banks." (BCBS 1988, 1)

In this passage the Basel Committee formulates its aims on a very abstract level. As it speaks about soundness *and* stability of the international banking system it is not clear how this aim should be achieved. While "soundness" serves as an expression primarily referring to the logic of the financial system, "stability" can be understood in a more general way. Destabilization can be evoked by very different developments or single events. Not only the loss of credits but also damages resulting from operational risks can destabilize a single bank and thus can bring dangerous irritations [Note: you probably need a different word here] for large parts of the whole banking system. The limits of the pure logic of capital adequacy attract the reader's attention a few lines later:

> "It should also be emphasised that capital adequacy as measured by the present framework though important, is one of a number of factors to be taken into account when assessing the strength of banks." (BCBS 1988, 2)

Taking into account this sequence, many aspects could be expected with regard to the strength of banks. Examples might be the capacity and security of the technological infrastructure, the competences of the responsible officers or transparency in the decision-making processes. These aspects can also provide specific risks for the banking system.[14] But the text passage makes quite a different selection, which underlines the narrow perspective of the approach in general:

[14] The failure of the Barings Bank in the middle of the 1990s is an instructive example in this respect as the traditional banking institute became a victim of a single manager who made risky transactions in Singapore that were not controlled in a satisfying way (Zhang 1995, 156)

> "The framework in this document is mainly directed towards assessing capital in relation to credit risk (the risk of counterparty failure) but other risks, notably interest rate risk and the investment risk on securities, need to be taken into account by supervisors in assessing overall capital adequacy." (BCBS 1988, 3)

This passage indicates that the Basel Accord follows the logic of capital. Not only did the framework not regulate organizational aspects but additionally, it did not even refer to these aspects, which are relevant but not treated in this context. Organizational aspects serve as unspecific non-knowledge of this framework.[15] They are neither regulated nor mentioned in the whole text. A further passage entails a very similar figure in which the text opens and reduces contingency in a specific way that demonstrates the underlying strategy of the document:

> "Furthermore, and more generally, capital ratios, judged in isolation, may provide a misleading guide to relative strength." (BCBS 1988, 2)

This sequence opens the possibility to refer to organizational aspects that were discussed in previous papers (see above). Especially the term "more generally" indicates a meta-perspective that gives an opportunity to mention further relevant aspects:

> "Much also depends on the quality of a bank's assets and, importantly, the level of provisions a bank may be holding outside its capital against assets of doubtful value." (BCBS 1988, 2)

At this stage, we can recapitulate that Basel I constitutes an order of knowledge for international financial regulation that excludes aspects lying beyond the logic of the financial system. This becomes obvious when we look at the concept of capital measurement itself as it is presented in the framework. In this concept, every international operating bank in the G10 countries was told to secure every credit by a capital ratio of eight per cent.

On the one hand, the paper reduces complexity by ignoring various possible types of risk and discrediting them as specific and unspecific non-knowledge. On the other hand the paper gains complexity as it differentiates between different forms of capital. The paper distinguishes different forms of capital that are suited to secure the liquidity of the bank. The

[15] For a systematic distinciton between specific and unspecific non-knowledge see Japp 2000.

most important capital is the ‘core capital’. This artificial category consists of “equity capital and disclosed reserves”. This capital is seen as a “key element” because it is “the only element common to all countries’ banking systems; it is wholly visible in the published accounts and is the basis on which most market judgements of capital adequacy are made.” On the second level, the text refers to “supplementary capital”[16] which can be used as additional capital (BCBS 1988, 4).

This hierarchy between different forms of capital refers to the central point of reference of the whole framework: the balance. The balance possesses an economic but also a legal form of rationality. It presents itself as a construction with a high level of objectivity that enables the harmonization of banking regulation in different nation states. It serves as a global model as the standard’s archimedic point of view becomes accepted and adaptable in modern states (Hessling 2006, 20).

Following this idea, the concept gives us an explanation of how this regulatory standard gains legitimacy in the national political legal system. The Basel Accord copes with the heterogeneity of the different countries by using a global norm. Furthermore, it represents an easy way of supervising the compliance of this standard on a global level. It became possible to compare different banking organization to each other with regard to the individual capital level.

After having ratified the Basel Accord in 1988 the Committee continued publishing several papers concerning different topics beyond the logic of capital based regulation.[17] Thus it can be assumed that the importance of organizational aspects was not denied completely; yet it did not expand into the codified regulatory knowledge of the national banking supervisors.

Ways of supervising banking organizations – the Basel Accord of 2004

Ten years passed until the Basel Committee made an effort to renew the first Basel Accord fundamentally and to establish a new order of knowledge that requires new forms of supervisory practices in the nation states. Thus, in 2004 the Basel Committee passed the second Basel Accord, which possessed nearly the same title as the first framework (BCBS

[16] In this context, the concept speaks of different forms of capital like “undisclosed reserves”, “revaluation reserves” or “General provisions/general loan-loss reserves”.
[17] A prominent example might be a paper concerning the risks resulting from telecommunication, published in 1989 (BCBS 1989).

2004).[18] At first sight, there are no essential differences between the two frameworks as far as the regulatory focus is concerned. Basel II even strengthens the importance of capital by prescribing new forms of capital measurement that are expected to be more risk sensitive. Consequently, main ideas are in accordance with the text of 1988, as the title and the formulated aim of the paper are nearly identical. Nevertheless, Basel II follows a different logic than the single logic of capital. A first example can be found in the introduction of the paper:

> „The Committee believes that the revised Framework will promote the adoption of stronger risk management practices by the banking industry, and views this as one of its major benefits.“ (BCBS 2004, 2)

In this passage, a term is used that was neglected in the whole first Basle Accord; the term "Management". This recourse to management can be considered as the first hint of a shift that is characteristic for the whole document. While Basel I only refers to measurement and the ideal of objectivity that is based on balance as a global norm, Basel II observes banking business in a more differentiated way, going beyond the pure logic of balance, credit and capital. 'Management' means to make a decision to cope with uncertainty and take different alternatives into account. While in Basel II, bank organizations were treated as perfect machines and organizational procedures were treated as an unmarked space, this field of risk is put into question in the new framework.

This does not mean that the framework gives up risk calculation by numbers and quantitative indicators. Far from it! Basel II elaborates complex formulas to calculate adequate capital ratio. It even extends the capital logic by aspects beyond financial aspects.[19] But beside this numbers-based quantitative rules it turns to a different mode as well:

> "438. All material aspects of the rating and estimation processes must be approved by the bank's board of directors or a designated committee thereof and senior

[18] The official title of the first framework was "International Convergence of Capital Measurement and Capital Standards". For the second accord the amendment "a revised framework" was added.

[19] This becomes clear when we refer to page 137 where the paper defines "operational risk" as a category that has to be secured by capital. Operational risk in this context "is defined as the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events. This definition includes legal risk, 90 but excludes strategic and reputational risk." Thus, the text gives a concrete example for the inclusion of non-financial aspects into the rationality of capital and measurement. It illustrates the enlargement of the regulatory focus in quite a different way.

> management." (BCBS 2004, 90)

With this passage, we get a further hint that Basel II goes beyond the regulatory approach of Basel I. In contrast to the first Accord, the text refers to organizational aspects like persons ("bank's board of directors", "senior management"). Not only does this framework prescribe specific capital ratios but it also formulates rules for the internal procedures in the banks, in an even more concrete manner in the following sequence:

> "80. These parties must possess a general understanding of the bank's risk rating system and detailed comprehension of its associated management reports. Senior management must provide notice to the board of directors or a designated committee thereof of material changes or exceptions from established policies that will materially impact the operations of the bank's rating system." (BCBS 2004, 90)

In this context it becomes evident that Basel II does not only refer to the pure logic of capital. The text speaks of "understanding" that can not be supervised by focussing on numbers. Thus, we can assume that quite a different regulatory order of knowledge is to be constituted by Basel II. These passages are not the only examples that illustrate the new focus, the new topics of this regulatory standard. In the second section of the framework, which is presented as the second Pillar,[20] the framework explicitly refers to the processes of the organization. We only want to demonstrate a few passages that illustrate the new quality of Basel II in relation to the previous framework:

> "However, increased capital should not be viewed as the only option for addressing increased risks confronting the bank. Other means for addressing risk, such as strengthening risk management, applying internal limits, strengthening the level of provisions and reserves, and improving internal controls, must also be considered. Furthermore, capital should not be regarded as a substitute for addressing fundamentally inadequate control or risk management processes" (BCBS 2004. 158).

Unmistakably, this passage makes clear that Basel II chooses a different approach to Basel I. It explicitly makes clear that capital is not seen as a substitute for organizational control. This general idea is strengthened by some detailed phrases in Pillar 2.

[20] The paper [Note: accord? agreement?] is divided into three pillars that deal with different regulatory/supervisory aspects. For more details see BCBS, 2004.

> “726. Banks must be able to demonstrate that chosen internal capital targets are well founded and that these targets are consistent with their overall risk profile and current operating environment.” (BCBS 2004, 159)

Thus, the logic of capital is embedded into the organization reality. The paper throws light on the processes in the environment of the core business. The organization has to demonstrate its productivity in risk management. It is no longer seen as a machine that works flawlessly. Instead Basel II prescribes a sophisticated approach that is able to distinguish between different levels of risk.

In sum, we can see that the second Basel Accord is not coupled on the logic of balances and the language of capital solely, on which the first regulatory approach was based. Instead, it is the formal organization with its technical processes, legal standards and personal competences and responsibilities that is an important subject of regulation. On the one hand, Basel II tries to quantify organizational things as we could see with respect to operational risk (see FN 19). Thus, they refer to the logic of numbers of measurement. But on the other hand, they intended to stabilize the international banking system by quite a different strategy of supervision.

As we pointed out, Basel I gained its legitimacy as a supranational framework being accepted and followed in the heterogeneous systems, by referring to the balance as an instrument of observation that serves as a global norm in economic and legal life. But this constellation brings up the question of how Basel II gains legitimacy? This question can be answered when we look at neo-institutional approaches that treat the organization as a world model as well as providing a set of rules and forms of social control (e.g. Meyer 2006, 41f.). But there are many differences between the “balances” and “organizations” as far as the decidedness is concerned. While the number-based form of the balances seems to provide clear normative statements, organizational structure, personal competences and technical can’t be put into a binary logic of right or wrong. This problem is marked by the term “adequate” which can be found in the framework, especially in passages, where organizational aspects are focussed on as a central theme.

Conclusion

If we take Basel II and the regulatory logic of this framework seriously, we can see that 'trust in numbers' might not be the basis for regulation any longer. Instead, the framework focuses on processes behind numbers. The production of numbers and the adequacy of formulas in a concrete organisational context are of central interest in the new approach. This in turn might have consequences for the content and regulatory practice as well. In some countries, the observation [Note: supervision? monitoring?] of bank organisations has already had a tradition that will only be modified by the new Basel II rules; the United States, for instance, has a regulatory system that includes on-site-inspections of regulators – a procedure that is termed "risk focussed approach" (DeFerrari 2001).

But in other countries such as Germany, consequences arising out of the new framework affect regulatory practices fundamentally. In these countries, banking regulators were concentrated on checking the balances, especially proving compliance of the 8 per cent standard. The new focus will entail new forms of regulation for them. While indicators of the balance and other numbers can be transmitted by modern communication systems, organizational reality, the understanding of processes and the security and stability of systems have to be proved on site.[21] This means that banking organizations as formal organizations might become vital points of reference for a political regulation and stabilization of the global banking system. As risks can't be buffered by the borders of the nation states any longer, international banking organizations serve as functional equivalents where financial flows can be accompanied by internal control systems.

Thus, we can observe an antidromic [Note: I understand this because I am Greek – but you are better off using another term here] development. While the banking system is globalized and spatial places do not matter in a traditional way any longer, banking regulation depends on interaction on site, on conversation in banks with the responsible persons. This procedure does not only mean a new challenge for the bank management who has to demonstrate the stability of its operational procedures, but it is a huge challenge for the banking supervisors who have to decide which procedures are "adequate" keeping in mind the central idea of the Basel Committee, the establishment of comparable supervision in heterogeneous contexts. Therefore the extent to which the organizational focus can cope with this demand in practice may become a key question.

[21] This is even prescribed in the framework but can't be analyzed in this paper in detail (BCBS 2004, 150).

A note on style: avoid as much as possible splitting words over two lines – this is very rarely done and you will need to change this for the working paper – have a look at some past WP in any case or look at the attached for any further format adjustments.

A note on substance: I think that this is an interesting and useful argument – though I am not very familiar with the approach, I ‘recognise’ the Basel process in what you are saying so I think that you are convincing enough.

There is a need to explain / clarify some things in the text, but the main issue I have is that you use regulation and supervision rather interchangeably – the functions are really rather different and it may be useful to be more precise about this.

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