Foreword

On April 7–8, 2005 the Financial Markets Group (FMG) of the London School of Economics (LSE) organized a conference on "The Future of Banking Regulation." This conference, the first in a planned series of annual events, brought together a group of prominent academics, bankers and regulators from around the world. The main focus was on the Basel II Accord, adopted by the Basel Committee on Banking Supervision in June 2004.

The Basel II Accord introduces a new capital adequacy framework for banks in order to respond to certain deficiencies in the 1988 Capital Accord ("Basel I"). The new Accord is structured around three "pillars." The first pillar focuses on *minimum regulatory capital requirements* and contains new rules for calculating more refined risk weights for different kinds of loans. Moreover, it suggests that capital should be held against operational risk. The second pillar is the *supervisory review process*, which requires supervisors to ensure that each bank has sound internal processes in place to assess the adequacy of its capital based on a thorough evaluation of its risks. The third pillar aims to bolster *market discipline* through enhanced disclosure by banks. Although the new framework's focus is primarily on internationally active banks, its underlying principles are intended to be suitable for application to banks of varying levels of complexity and sophistication. Implementation of the Basel II Accord is foreseen for 2007 for the simpler approaches and 2008 for the most advanced approaches embodied in the Accord.

In this special issue of the journal *Financial Markets, Institutions & Instruments* a selected number of the papers presented at the conference are published. The first paper is by Sir Howard Davies, Director of the London School of Economics & Former Chairman of the Financial Services Authority. In his "Review of the Review" Davies addresses some of the problems, such as complexity, potentially perverse consequences, and the extent to which the Accord is implementable. The second paper is by Jaime Caruana, Chairman of the Basel Committee on Banking Supervision & Governor of the Bank of Spain. In his contribution on the "Implementation of Basel II," Caruana gives an update on the current status of Basel II, offers his perspective on macroeconomic issues (such as procyclicality) related to Basel II, and discusses three important implementation issues: calibration, validation, and cross-border supervision. In the third paper, Professor Richard Herring of the Wharton School at the University of Pennsylvania provides a critical view under the heading "Implementing Basel II: Is the Game Worth the Candle?" Herring argues that Basel II will be very costly for banks, home country and host country supervisors, and, to the extent that it exacerbates macroeconomic cycles, to the broader economy as well. The fourth paper is by Professor Harald Benink of RSM Erasmus University & FMG/LSE and Professor George Benston of the Goizueta Business School at Emory University. In their paper "The Future of Banking Regulation in Developed Countries: Lessons from and for Europe" Benink and Benston present new data on the historical decline of bank capital/asset ratios in 10 European countries since the nineteenth century and propose two alternative regulatory requirements (relatively high capital *or* collaterized deposits) to deal with this. The fifth paper is by Dr. Jón Daníelsson of the London School of Economics and Dr. Ásgeir Jónsson of the University of Iceland. In their contribution, entitled "Countercyclical Capital and Currency Dependence" Daníelsson and Jónsson argue that the introduction of risk sensitive bank capital charges into currency dependent economies exasperates the inherent procyclicality of banking regulations and frustrates the conduct of monetary policy. By requiring capital charges resulting from foreign currency lending to be denominated in the same foreign currency, the capital charges become countercyclical. In the sixth paper Professor George Kaufman of Loyola University Chicago addresses the question "Basel II vs. Prompt Corrective Action: Which Is Best for Public Policy?" According to Kaufman it is time to reconsider the benefit-cost tradeoff of Basel II versus a U.S. approach involving structured early intervention and resolution (SEIR) and prompt corrective action (PCA). The seventh and final paper is by Professor Clas Wihlborg of Copenhagen Business School. In his paper on "Basel II and the Need for Bank Distress Resolution Procedures" Wihlborg argues that market discipline, and the credibility of non-insurance of certain groups of bank creditors (such as holders of subordinated debt), could be enhanced if distress resolution procedures for banks were pre-specified, and if they enabled bank failures to take place without serious disruption of the financial system.

We would like to thank all conference participants for their active involvement in the discussions. Finally, we are indebted to the FMG/LSE's administrative staff, who provided invaluable assistance in organizing the conference.

Harald Benink
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Harald Benink has been Full Professor of Finance at RSM Erasmus University in Rotterdam, the Netherlands since 1999. Name of the chair is "Institutional Design of Integrating Markets." Prof. Benink is also a Senior Research Associate to the Financial Markets Group at the London School of Economics. He holds a Master's degree in Economics from Tilburg University, a Master's degree in Financial Economics from TIAS Business School (Tilburg University) and received his Ph.D. degree in Finance and Economics from Maastricht University. The thesis was entitled "Financial Fragility." Prof. Benink's research focuses on banking and finance and on European financial and monetary integration. He has published in various academic journals (including *The Journal of Finance*) and has also published a couple of books (including *Financial Integration in Europe*). He is frequently cited in international financial newspapers such as *The Economist* and *Financial Times*. Furthermore, he is Founder and Chairman of the *European Shadow Financial Regulatory Committee* (1998) and Founder and Invited Member of the *Latin American Shadow Financial Regulatory Committee* (2000) and the *Asian Shadow Financial Regulatory Committee* (2004). The Shadow Financial Regulatory Committees consist of prominent professors and other independent experts, issuing policy recommendations in the areas of regulation and supervision of financial institutions and markets.

Jón Daníelsson has a Ph.D. in Economics from Duke University, and is currently a Reader in Finance at the London School of Economics. His research areas include financial risk, hedge funds, regulation of financial markets, market volatility, liquidity, models of extreme market movements, and microstructure of foreign exchange markets. He has been a Visiting Professor at universities in the United States, the Netherlands, Germany, Iceland, and Spain, and has published in a range of academic and practitioners' journals.

Charles Goodhart, CBE, FBA is a member of the Financial Markets Group at the London School of Economics (LSE), having previously, 1987–2005, been its Deputy Director. Until his retirement in 2002, he had been the Norman Sosnow Professor of Banking and Finance at LSE since 1985. Before then, he had worked at the Bank of England for 17 years as a monetary adviser, becoming a Chief Adviser in 1980. In 1997 he was appointed one of the outside independent members of the Bank of England's new Monetary Policy Committee until May 2000. Earlier he had taught at Cambridge and LSE. Besides numerous articles, he has written a couple of books on monetary history; a graduate monetary textbook, *Money, Information and Uncertainty* (second edition, 1989); two collections of papers on monetary policy, *Monetary Theory and Practice* (1984) and *The Central Bank and the Financial System* (1995); and a number of books and articles on financial stability, on which subject he was Adviser to the Governor of the Bank of England, 2002–2004; and numerous other studies relating to financial markets and to monetary policy and history. In his spare time he is a sheep farmer (loss-making).