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Daniel Mügge/Bart Stellinga

Absent alternatives and insider interests in post-crisis financial reform¹

Zusammenfassung

Der Mangel an Alternativen und Insiderinteressen in Finanzmarktreformen seit der Krise

Die Kreditkrise, ausgebrochen im Sommer 2007, hat gängige Regulierungsmodelle und die ihnen zugrunde liegenden politischen Institutionen grundsätzlich in Frage gestellt. Gemessen an der fundamentalen Kritik die seitdem an bestehenden Strukturen geäußert worden ist, sind die Reformambitionen westlicher Regierungen in diesem Bereich allerdings enttäuschend und geben kaum Hoffnung, dass der Bedrohung durch zukünftige Krisen ernsthaft begegnet wird.

Diese Beobachtung generiert die zentrale Frage dieses Beitrags: wie lassen sich die Reformschritte verschiedener Regierungen, und insbesondere deren begrenzter Umfang, erklären? Unsere Analyse konzentriert sich auf die Reformpositionen die vier Regierungen mit Schlüsselpositionen in globalen Finanzfragen (USA, Großbritannien, Frankreich, Deutschland) im Vorfeld der G20-Treffen 2009 eingenommen haben. Vier Regulierungsfeldern stehen dabei zentral: Rechnungslegungsstandards, Derivathandel, Bankenregulierung und Ratingagenturen. Der Beitrag nimmt dabei sowohl bemerkenswerte Überlappungen der Regierungspositionen sowie Unterschiede zwischen ihnen in den Blick. Vor allem letztere erlauben Rückschlüsse auf die treibenden Kräfte hinter Reformbemühungen.

Die Analyseergebnisse lassen sich wie folgt zusammenfassen: Regierungen haben in internationalen Verhandlungen die Wettbewerbsinteressen ihrer nationalen Finanzdienstleister verteidigt. Das heißt nicht, dass Industrieinteressen durchgängig in politische Positionen übernommen worden sind – nicht selten haben neue Regeln Bankprofite eher geschmälert. Vielmehr ist es der relative Einfluss der neuen Regeln auf Wettbewerbsfähigkeit gewesen, verglichen mit ausländischen Firmen, der entscheidend war.

Gleichzeitig zeigt dieser Beitrag, dass die verschiedenen Regierungspositionen sich alle innerhalb

Abstract

The credit crisis that began in the summer of 2007 has fundamentally challenged much financial regulation and the political institutions that produced it. Measured against the criticisms that have been brought forth against previous financial governance, the extent of governments' overall reform ambitions has been disappointing, generating little hope that the threat of future crises is being tackled seriously.

Starting from this observation, this article asks: what explains governments' reform choices, and thus also their limited ambitions? To explore this question, this article focuses on the positions that four governments central to global financial regulation (the USA, the UK, Germany and France) have taken in advance of the G20 meetings in 2009 across four key issue areas in financial regulation: accounting standards, derivatives trading, credit ratings agencies and banking rules. It evaluates both the overlap between positions across domains and governments as well as the differences between them. Such variation, we argue, provides key clues to the overall drivers behind reforms – as well as their limits.

The overall picture that emerges can be summarized as follows: governments have been staunch defenders of their national firms' competitive interests in regulatory reforms. That has not necessarily meant that they followed industry preferences across the board – new rules that might dent profits were imposed in several cases. It has been the *relative* impact, compared to foreign competitors, that counted in reform positions, not the *absolute* impact.

As this article also shows, these differences of opinion have played out within the context and the limits of the overall debates about thinkable policy alternatives. In spite of fundamental criticisms of pre-crisis regulatory orthodoxy, convincing and coherent alternatives have been forthcoming slowly at

eines Rahmens bewegen, der auf ‚denkbare‘ Regulierungsalternativen begrenzt ist. Ungeachtet der Fundamentalkritik gegenüber dem seinerzeit gängigen Regulierungsparadigma, die nach der Krise laut geworden ist, mangelt es nach wie vor an überzeugenden, grundlegenden Alternativansätzen. Darum sind viele Reformvorschläge weniger radikal ausgefallen als die Kritik, isoliert betrachtet, nahegelegt hätte.

Schlagworte: Finanzmarktregulierung, private Akteure, Kreditkrise, Banken.

best. This has made reform proposals less radical than criticisms, seen on their own, might suggest.

Key words: Financial regulation; private actors; credit crisis; capture.

1. Introduction

The credit crisis that began in the summer of 2007 has fundamentally challenged much financial regulation and the political institutions that produced it (*Financial Services Authority* 2009; *High-Level Group on Financial Supervision in the EU* 2009; *The Warwick Commission on International Financial Reform* 2009; *Kessler* forthcoming 2010). Authors from widely differing backgrounds diagnosed flaws in pre-crisis regulatory thinking and attacked the intellectual core of the prevailing ‘regulatory liberalism’ (*Gamble* 2009, p. 153). Yet measured against these criticisms, the extent of governments’ overall reform ambitions has been disappointing, generating little hope that the threat of future crises is being tackled seriously.

This observation is the point of departure for this article: what explains governments’ reform choices (and thus also their limited ambitions)? To explore this question, we focus not only on shared government positions on necessary reforms but also on the differences between them. Such variation, we argue, provides key clues to the overall drivers behind reforms. It can be found both across countries and issue areas. France, for example, continues to favour more re-regulation than the UK. And while some countries seek restrictive rules for credit rating agencies or over-the-counter derivatives, others prefer fundamental reforms of accounting standards or the Basle capital adequacy regime. How can we account for these differences?

The overall picture that emerges can be summarized as follows: governments have been staunch defenders of their national firms’ competitive interests in regulatory reforms. That has not necessarily meant that they followed industry preferences across the board – new rules that might dent profits were imposed in several cases. It has been the *relative* impact, compared to foreign competitors, that counted in reform positions, not the *absolute* impact.

As this article also shows, these differences of opinion have played out within the context and the limits of the overall debates about thinkable policy alternatives. In spite of fundamental criticisms of pre-crisis regulatory orthodoxy, convincing and coherent alternatives have been forthcoming slowly at best. This has made reform proposals less radical than criticisms, seen on their own, might suggest.

This paper proceeds in four steps. The following section develops a rough yard-stick to allow a comparison of reform proposals and measures across policy domains. Section three details the argument in theoretical terms and locates it in contemporary debates about financial governance. Section four introduces the four policy domains central to

this article – accounting standards, capital adequacy rules, credit rating agencies regulation and derivatives regulation – and presents evidence on regulatory reform positions of the four countries that have arguably taken the most prominent roles in global reform debates: Germany, France, the UK, and the US. The choice for the four mentioned domains follows from their centrality in public debates about sources of the crisis and key areas for reform. At the same time, they exhibit variance across key dimensions that enable an evaluation of potential explanations. Naturally, post-crisis reform is a moving target as discussions continue both at the national level and in the G20 and other international forums. This article therefore concentrates on government reform positions at a key moment in the post-crisis reform trajectory: the preparations for the two G20 summits of 2009. It presents a snap-shot that allows us to understand better the drivers of the reform process, even if its ultimate results are yet unknown. Section five concludes and compares dynamics across the four policy domains.

2. An open door for regulatory reform

Leading liberal commentators such as *Martin Wolf* and *Wolfgang Münchau*, prominent financiers such as *George Soros*, and major policymakers like *Lord Turner*, head of the former British Financial Services Authority, have all voiced fundamental criticisms of the pre-crisis financial market order (*Soros* 2008; *Financial Services Authority* 2009; *Münchau* 2009). Drawing on the ideas of for example *John Maynard Keynes* (1964 [1936]; cf. *Best* 2004) and *Hyman Minsky* (2008 [1986]), many critics have questioned the soundness of the paradigm underpinning pre-crisis regulation. Much of the criticism has focused on ‘market-enhancing regulation’, which assumed markets’ efficiency and their propensity to discover optimal prices for financial assets given abundant liquidity and, crucially, sufficient information for market participants. Information asymmetries as a prime cause of market failure had to be rectified through regulation, just as intra-industry competition and liquidity might have to be supported through specific rules. With such props in place markets could be trusted to spawn an efficient and relatively stable financial system.

Critics have argued that markets are reflexive, meaning that market sentiment is inseparable from any ‘objective’ economic reality (*Soros* 2008). Valuations of financial assets should *reflect* observers’ judgements about future economic developments and other market participants’ perceptions. At the same time, these valuations and the investment decisions based on them *shape* future economic developments, for example by fuelling market bubbles or spurring productive investment. As *Keynes* already recognized, and as financial crises through the ages have demonstrated time and again (*Kindleberger* 1978; *Reinhart/Rogoff* 2009), the resulting subjectivity pushes financial markets towards destructive boom-bust patterns rather than towards equilibrium. Regulation to address these excesses would have to be ‘market-disciplining’ rather than market-enhancing.

The critics who have put reflexivity at the heart of their analyses of the financial crisis have seemingly opened the door to wholesale overhaul of policy in diverse financial market domains, including banking and derivatives regulation, the functioning of credit rating agencies and accounting standards. Based on such criticism and its prominence in public debates, one should expect that governments, eager to prevent future crises, would seek reforms that rectify the intellectual deficiencies of previous regulatory regimes.

When this article analyses variation across countries and policy domains, it therefore also focuses on the degree to which reform proposals depart from the regulatory liberalism that characterized pre-crisis policy and base new policy on an alternative regulatory paradigm that takes market reflexivity seriously.

3. Reform politics in crisis times

In some policy domains, reforms have already been introduced; new EU rules on credit rating agencies are one example. In many others discussions are ongoing. To the degree that governments have incentives to reconcile divergent positions through bodies such as the G20, or are even forced to do so in the context of the EU, eventual reforms will differ from governments' original preferences. This paper concentrates on these preferences, however, to understand to which degree fundamental reform is even considered in national capitals, irrespective of the limits that collective action problems may impose on its implementation. In this article's assessment of regulatory reform politics in crisis times, two strands of thinking provide most inspiration: dynamics of ideational change, and the importance of firms' competitive interests.

3.1 A lack of alternatives

The preceding section spelt out criticism of regulatory liberalism on the basis of an acknowledgement of financial markets' reflexivity. Such criticism is convincing and, with the benefit of hindsight, much more than just academic musing on the cognitive fundamentals and social construction of asset values and future expectations. *Hall* (1993), building on *Kuhn* (1962), laid out how fundamental policy change requires the previously dominant paradigm to have become dysfunctional. Faced with obstinate reality, it must have hit an intellectual cul-de-sac and ceased to provide explanations with its own former shortcomings. If ever there was a cognitive window of opportunity for a thorough rethink of financial governance, the credit crisis opened it widely. What we know about cognitive dynamics in economic policy would suggest radical reform to be possible, even if not necessarily likely.

At the same time, the possibility of alternative paradigm implementation cannot be assessed independent of the specific ideas newly put on the table. The indeterminacy of financial markets that the reflexivity paradigm highlights may make the formulation of convincing policy alternatives difficult. *Minsky* himself (2008 [1986]) saw no easy way out of the boom-bust cycle he described. To the degree that regulatory policy relies on objective assessments of adequate valuations – whether by credit rating agencies, banks' internal risk models, derivative valuations or through accounting standards – it is not obvious how policy could be formulated that remains true to market reflexivity. The question, then, is whether beyond criticisms of the status quo, advocates of an alternative view of financial market functioning have been able to sketch regulatory regimes that could serve as templates for the radical reforms that they demand. Their absence need not preclude radical reform, but off-the-shelf alternatives clearly make such changes easier. The availability or otherwise of such alternatives in regulatory debates could thus explain why in some domains we see fundamental reform proposals whereas marginal adaptations

dominate in others. In any case, it remains an open question whether the crisis in financial markets has engendered a regulatory rethink capable of generating far-reaching reform.

3.2 Competitive interests of firms

Variation across government responses may also stem from the competitive interests of national firms. The influence of firms' preferences on financial regulation and international agreements has been widely documented (*Sobel* 1994; *Underhill* 1997; *Oatley/ Nabors* 1998; *Kroszner/Strahan* 1999; *Mügge* 2006b; 2006a; forthcoming 2010b; *Gadinis* 2008). This literature documents that it is not primarily firms' short-term interest in boosting profits that counts – *absolute* benefits as it were. What matters most are the *relative* benefits firms derive from legal changes: do they fare better than their competitors?

There are good reasons to believe that the competitive interests of firms play a lesser role now than they did before the crisis. *Singer* (2004) for example argued that in international efforts at rule harmonization financial regulators face a trade-off between enhancing financial stability and tilting the terms of cross-border competition in favour of national firms. Following this line of reasoning, recent efforts to buttress the resilience of global finance through regulatory reform would reduce the weight of firms' competitive interests.

In addition, industry-led financial liberalization has partially thrived on the lack of awareness among citizens and their representatives of how essential a domain of policy-making financial regulation is. Pre-crisis financial regulation was a form of insider politics (*Mügge* forthcoming 2010b). Capture of regulation by firms was possible because no other societal stakeholders contested firms' input into the policy process.

The financial crisis has politicized financial regulation across the developed world. Several countries, including the UK, the Netherlands and the US, have held public parliamentary hearings with regulators, government officials and financial industry representatives as witnesses. More than once, these hearings assumed a court-like character, and private-sector witnesses were frequently recast as villains. Several ad hoc government measures, including hefty taxes on banker bonuses, responded to a perceived public awareness of and anger over private-sector failings. Whereas pre-crisis, governments stressed the technicality of regulation and the importance of their own non-involvement, they are now once more in charge of steering financial markets – for better or worse.

This politicization of regulation could have contradictory effects, however. On the one hand, it may have alerted politicians to the importance of regulation and fomented distrust towards industry opinion in regulatory matters and market-oriented regulatory orthodoxy. In addition, the position of government officials eager to impose restrictions on the financial industry has now been strengthened significantly. On the other hand, as governments have reluctantly been drawn deeply into financial market governance – at times through outright ownership of banks – they may feel even more responsible for their firms' fate than was true before. The realization that financial firms perform crucial public functions may entice governments to watch out carefully for their survival, and hence competitiveness. Ironically, the politicization of regulation may have given governments incentives to safeguard the interests of their financial industries even more. It is not obvious that a trade-off between stability and 'competitiveness' as highlighted by *Singer* (2004) still structures post-crisis reform politics.

Both arguments about paradigmatic change in policy and the preponderance of industry interests in financial governance may thus have to be re-evaluated in the post-crisis context. The credit crisis has clearly shaken the prevailing regulatory orthodoxy, paving the way for change. At the same time, the specific criticisms offered against pre-crisis regulation may have been so fundamental that they are unable to generate practical policy alternatives. And the crisis may have either weakened or strengthened firms as policy insiders. How each of these dynamics played out is for the empirical cases to tell.

4. The empirics: Country positions in four policy domains

This section compares government reform preferences across four domains: accounting standards, credit rating agencies, capital adequacy rules and derivatives regulation. Faulty rules in each of these fields have played a role in the financial crisis (*Hellwig 2008; Kragt 2008; Financial Services Authority 2009; Siddiqui/Sekkelmann 2009*), even if observers differ in the relative weight they assign to them.² The two G20 summits of 2009, one in London in April and one in Pittsburg in September, challenged governments to articulate policy positions for these fields. Only in few cases did these positions change throughout 2009. More often, governments voiced deeply-rooted attitudes that might change as a result of bargaining, but not through persuasion by better arguments.

4.1 Accounting standards

Fair-value accounting (FVA), the paradigm that replaced historic cost accounting over the past two decades (*Barlev/Haddad 2003*), has drawn criticism for allegedly increasing volatility of financial institutions' profits and losses, at times pushing banks into bankruptcy purely on the basis of adapted valuations of securities even if their cash flow position was sound (e.g. *Hellwig 2008*, for a critical view see *Laux/Leuz* forthcoming 2010). More seriously, as FVA forced financial institutions to treat corrections in the market valuations of credit derivatives and loan portfolios as losses, it triggered asset sales and curbs on lending, which themselves induced further falls in these assets' market valuations. And when market liquidity dried up, uncertainty spread about the value of banks' assets, triggering a collapse in interbank lending. FVA was an essential link in the chain of what *Turner* called 'hard-wired procyclicality' (*Financial Services Authority 2009*, pp. 22ff.). The apparent weaknesses of FVA (e.g. *Perry 2009*) thus opened the door for a wide-ranging discussion about regulatory overhaul.

Practical reform discussions sidestepped profound theoretical debates. Empirically, differences of opinion between governments in the field of accounting standards revolved around two core questions: first, how strictly should mark-to-market accounting, a core aspect of FVA, be applied to financial institutions' assets? And second, how important is it that accounting rules be harmonized globally, meaning in particular that the International Financial Reporting Standards (IFRS) drawn up by the IASB should be in line with the rules of the Financial Accounting Standards Board (FASB), the IASB's US counterpart?

In practice American authorities have been ambivalent about mark-to-market accounting, even if they have continued to support it in principle. Since a remarkable shift

of policy in favour of recognizing IFRS, they have stressed the importance of internationally compatible accounting standards, and the FASB as well as the Securities and Exchange Commission (SEC) proposed that US public companies should be able to use IFRS in their SEC filings by 2014 (*US Government Accountability Office* 2009).

Already in September 2008, the SEC and FASB had issued guidance on 'fair' asset valuation in thin or disorderly markets, granting firms more leeway to estimate asset values themselves rather than using mark-to-market. Despite this guidance, in March 2009 Congress threatened regulators, calling on them to improve the standards lest it would do so itself (*Hughes* 2009). Although *Geithner* expressed his reservations about suspending mark-to-market accounting (*Braithwaite/O'Connor* 2009) in April 2009 US regulators allowed financial institutions to use their own cash flow models during distressed times and to recognize only part of any drops in asset values in their income statements (*The Economist* 2009; *Guerrera et al.* 2009). This move chimed with calls by large banks such as Citigroup, Bank of America and Wells Fargo to relax accounting requirements, particularly for assets held for long periods of time (*Guerrera et al.* 2009). Investors, financial analysts and accountants themselves unsuccessfully opposed such rule changes, arguing that they undermined investors' confidence in published accounts.

The UK consistently came out in favour of sticking with mark-to-market accounting. Backed in this stance by the UK government (*HM Treasury* 2009, p. 78), *Lord Turner* argued in his regulatory review that market freezing had stemmed less from faulty accounting rules but from a lack of transparency (*Financial Services Authority* 2009). In consequence, the UK officially favoured accounting reforms that forced firms, and banks in particular, to disclose more information. This position mirrors that of the IASB itself, which originally planned to extend mark-to-market accounting in response to the crisis. However, as a result of enormous political pressure from Continental EU members, particularly France and Italy, the IASB introduced FASB-like exceptions in October 2008 and started revising the accounting standard in question after the G20 summit in London.

The German government had been sceptical of fair-value accounting applied to financial assets even before the financial crisis. In 2007, as problems started to emerge, *Axel Weber* as head of the Bundesbank argued that triple-A rated credit derivatives should not be marked to the (falling) market as they were unlikely ever to suffer real losses (*Tett* 2009, cf. *Weber* 2009a). Early in 2009 Germany floated plans to allow banks to park impaired assets in separate entities and to allow them to use traditional German accounting rules for these, meaning that they would be recorded at book – rather than market-value (*Benoit/Wilson* 2009). According to the IMF, many German financial institutions had continued to use book rather than market values for their assets even after IFRS had officially been introduced in the EU in 2007, implying (by IFRS-standards) enormous unrecognized losses (*Tett* 2009).

Unsurprisingly then, German finance minister Steinbrück welcomed the relaxation of IASB rules to align them with FASB requirements in October 2008 and the IASB's promise in June 2009 to develop a more adequate standard for financial instruments (*Hekkingen/Visser* 2009). By July, however, he still felt reforms away from mark-to-market accounting proceeded too slowly and, together with his French counterpart *Lagarde*, sent a letter to Internal Market Commissioner McGreevy urging accounting standards to be altered so that US and European banks could compete 'evenly' (*Business World* 2009).

Of the four governments, France was by far the most vociferous in its attacks on mark-to-market accounting, extending criticism to the IASB and its governance structure

itself. French prime minister Fillon not only argued that accounting should be less pro-cyclical, but he also urged that the IASB should become more transparent and representative (Fillon 2009), calling into question the technocratic expertise on which its claim to legitimate policy-making was built. Finance minister Lagarde concurred, calling for reform of both accounting rules and the IASB in April 2009. Regulators and supervisors should have a say in IASB rule-making and, in line with Steinbrück's position, accounting rules should be adjusted according to the assets' liquidity and investors' holding horizon (Lagarde 2009a). President Sarkozy reportedly went as far as decrying the *coup* of accounting rules by 'technocrats' as one of the causes of the crisis (Camerlinckx 2009).

That said, France continues to claim that in principle it supports fair-value accounting as such (Betts 2009); it only wants it applied to the 'appropriate' activities, meaning that long term assets should not be marked-to-market. Needless to say, such a selective application of FVA undermines the whole intellectual rationale behind it. Yet the French position mirrored that of large domestic financial firms such as BNP Paribas (Daneshkhu 2009) and Axa, France's largest insurer (Daneshkhu/Hughes 2009). Whatever the ultimate outcomes, the French government continues to stress that accounting rules between US and Europe would need to be harmonized in the end (Noyer 2009a). In contrast to pre-crisis calls for rule convergence, however, the argument no longer referred to increased capital market efficiency but a 'levelling' of the playing field with US firms as stricter IASB rules might disadvantage European banks (see Daneshkhu 2009).

What is the overall picture that emerges? The UK proved the staunchest supporter of FVA, with the US in an intermediate position and both Germany and France sceptical in practice, if not in principle. US authorities, not least Congress, took a pragmatic approach to accounting rules (cf. Mügge forthcoming 2011a), meaning that they were willing to dilute FVA principles to grant national firms some respite. This decision, in turn, triggered calls for reform by the French and German governments to protect the interests of their national financial industries under the catch-all banner of creating 'a level playing field'. In spite of general scepticism towards FVA in both countries, however, they professed continuing support for the underlying principle. Neither offered an alternative approach, but argued in favour of relaxed rather than wholly different rules. Doubts about the underlying paradigm were less important as a source of criticism than its practical market consequences.

In this light, the British position is surprising. On the one hand, Lord Turner in his authoritative review clearly demonstrated his disaffection with pre-crisis regulatory orthodoxy; his analysis has been the most encompassing criticism of such orthodoxy from a senior policy maker in the countries studied here. On the other hand, Britain emerged as the strongest supporter of FVA. But maybe Lord Turner's weight in the British debate is also the key to his position. Whereas the other three countries were willing to advocate half-baked approaches with much lower coherence than FVA has had, the British position reflects most clearly that no wholesale alternative to FVA has been offered so far, and in consequence favours an even stricter application of the prevailing paradigm rather than what in the German, French and US positions amounts to little more than 'muddling through'.

4.2 Capital adequacy

With hindsight, banks' capital buffers relative to their assets are widely seen as having been too thin. At the moment of most extreme indebtedness, the US median bank had

borrowed 37 times its own capital (*The Economist* 2010); relatively minor re-valuations of assets quickly eroded financial institutions' capital bases and forced them into bankruptcy. More capital relative to assets is considered a sine qua non for any future revision of the capital adequacy regime.

Beyond simply thickening the capital buffer, two thorny issues stand out. First, because assets have been risk-weighted in the calculation of capital that needed to be put aside to back them up, banks' capital blankets grew thinner in relatively calm but potentially excessive market-upswings when defaults were rare. In consequence, banks had and used extra room to extend lending, further feeding the credit boom. As has been often noted, capital requirements were pro-cyclical. Second, Basle II rules emphasized 'sophisticated' forms of risk-weighting, relying either on external ratings, discussed below, or banks' own risk-assessment models (the internal ratings-based approach, see *Tarullo* 2008). The credibility of both methods has been seriously dented by the crisis, but thus far at least, wholesale alternatives to calculating appropriate capital buffers are lacking.

For reform proposals targeting capital adequacy rules, the picture is somewhat different than the one for accounting standards. In general, all countries agreed: banks need more capital relative to assets, and the pro-cyclical effects of waxing and waning capital buffers when they are risk-weighted should be countered. What was contentious, however, was whether measures to achieve this should be brought into Basle accord reforms or whether separate agreements (if any at all) should formalize such rules.

Even before the crisis, European members of the Basle Committee on Banking Supervision had been dismayed by the limited range of banks to which the US was willing to apply such rules and its reluctance to implement the agreement fully. As was true for accounting standards, EU governments were and are afraid that whereas they have tied themselves to international standards, often legally binding through their incorporation in or implementation through EU-wide rules, the US would seriously consider unilateral regulatory solutions (cf. *Mügge* forthcoming 2011b).

Indeed, in the American regulatory discussion such unilateral moves have been considered viable options (US Government Accountability Office 2009), not least because of the fragmentation of American regulatory institutions which might necessitate idiosyncratic solutions. In line with the US decision to apply Basle II only to large, systemically relevant institutions (*Braithwaite/Guerrera* 2009; *Geithner* 2009), extra domestic 'safeguards' have been touted as key measures to strengthen the resilience of the American financial system. In addition to the calculation of capital buffers 'through the cycle' (however that might work), the US has focused on three further measures for international implementation: the introduction of a leverage ratio (capital to non risk-weighted assets, cf. *D'Hulster* 2009), the application of capital adequacy rules to a broader range of assets (*Department of the Treasury* 2009a) and an increase in importance of tier-1 capital (*Irish Independent* 2009).

In the run-up to the Pittsburgh summit in September 2009, this last proposal led to conflicts with European countries, especially France and Germany. Before proposing altogether new rules, these two countries argued, the US should first fully implement Basle II (*Agence France Presse* 2009; *Irish Independent* 2009) and they insisted that leverage ratio-rules should fall under the Basle regime (*Guha* 2009). In short, both countries worried that the Americans would opt out of global banking governance and pursue their own, independent policy line.

In substance, the British position mirrored that of the US. Also in the UK, stronger capital buffers were seen as the key to prevent future re-runs of the crisis (*Financial*

Services Authority 2009), and authorities stressed the importance of smoothing out capital requirements throughout the credit cycle (*Financial Services Authority* 2009, p. 62; *HM Treasury* 2009). The British also saw added value in a leverage ratio and, crucially, argued that stronger capital bases should come in the form of shareholder equity – not unlike Geithner's emphasis on tier 1 capital.

In contrast to both the US and the UK, Germany continuously emphasized the importance of the Basle accord as the backbone of banking regulation. In the summer of 2009 Steinbrück had indicated support for a temporary relaxation of capital rules (*Tait et al.* 2009), complementary to his plea for looser accounting rules (*Tett* 2009). Overall, however, Germany was in favour of letting the (potentially amended) Basle accord do the trick. *Axel Weber*, head of the Bundesbank, warned in September not to dismiss the risk-sensitive approach of Basle II and urged to wait with reforms until a Basle working group had determined whether the regime had in fact stimulated pro-cyclicality (*Weber* 2009a).

Weber also made clear that he was against introducing a leverage ratio outside of the Basle context, arguing that this would lead to competitive distortions due to differences in accounting standards (*Weber* 2009b). According to the OECD (2010, p. 8), German banks' capitalisation was very low on a non-risk weighted basis, meaning that the introduction of such a ratio would constrain their lending capacity much more than that of banks domiciled elsewhere. In the end, *Weber* voiced relief that the G20 decided to incorporate the leverage ratio in pillar 2 of the Basle accord and that G20 members committed to implement Basle II by 2011. What mattered for Germany was strict implementation of Basle rules, not their radical overhaul.

One particular bone of contention was the emphasis the US and the UK put on shareholder capital in efforts to strengthen banks' capital bases. With thousands of cooperative and publicly owned (savings) banks, Germany has been hesitant to focus on shareholder equity, fearing that the capital base of banks that are not publicly traded will be treated less favourably, meaning that such banks would either have to raise additional capital or curtail lending (*Wilson* 2009).

Roughly mirroring the German position, France has demonstrated strong support for the Basle II framework (*Noyer* 2009b) while acknowledging the desirability of rules that dampen the peaks and troughs of the lending cycle (*Lagarde* 2009a). It also is cautious about Anglo-American proposals to increase the amount and quality of banking capital (*Irish Independent* 2009), with French banks warning against 'unfair competition' because of rule changes in the lead-up to the Pittsburgh summit (*Daneshkhu* 2009).

In banking, then, the division of roles is different from that in accounting: France and Germany have both been worried that the US would effectively opt out of the implicit Basle commitment to formulate common rules for the banking sector. The US, never having been too happy with Basle II in the first place, has continued to drag its feet. The UK, while ultimately interested in a global deal (not least because it too is covered by EU legislation in the field) has been willing to stand by while the US bargained to extract concessions from France and Germany in return for a commitment to Basle II.

In parallel with the situation in accounting, the main lines of disagreement traced the competitive fault lines between national financial industries. The easy regulatory lessons, namely that capital blankets were too thin, have quickly been learned by all governments. In contrast, the more difficult questions – how could regulatory capital be set in a way to reflect expectations of future up- or down-turns? – have barely been touched upon in international debates.

4.3 Rating agencies

The triple-A ratings credit raters issued for credit derivatives in the run-up to the crisis quickly became one of the most visible faults in the chain of events that brought the global financial system down. The retrospective accusations against credit rating agencies (CRAs) have been manifold: the use of quantitative models that relied on historical data, the lack of qualitative judgements about overall market stability, and a business model in which CRAs faced a clear conflict of interest, given that they were paid by the issuers of the securities they had to judge and also made money by advising issuers on how to construct structured credit derivatives.

Of the cases discussed here, the area of credit rating agencies has seen the most legislative action so far. The EU introduced a regulation in the field in November 2009 mandating registration of rating agencies active in the EU, publication of their methodologies, and a prohibition on providing advisory services and ratings for products about which they have insufficient information. As argued below, determined collective action from European governments in this field – contrary to the other cases discussed here – can be traced directly to the absence of important European rating agencies.

With the passing of the Credit Rating Agency Reform Act by Congress in 2006, US authorities had already strengthened CRA oversight and recordkeeping-requirements in response to the WorldCom and Enron scandals (US Government Accountability Office 2009). The SEC introduced further regulation at the end of 2008 warning, however, that excessive government intervention would unintentionally legitimate ratings and stimulate undue reliance on them (*SEC Working Group 2008; US Government Accountability Office 2009*). Rating methods henceforth had to be more transparent and the direct reference to specific ratings in ancillary legislation was weakened (*Bos 2008*). The following year, the SEC started work on CRA requirements to differentiate between structured and unstructured products and CRA business models, which many observers had argued had generated perverse incentives (*Department of the Treasury 2009a*, p. 46).

Unsurprisingly, US authorities were unhappy about EU oversight over CRAs (*Beary 2009*), arguing that they themselves were already taking the appropriate (and necessary) steps to make sure that henceforth, CRA activities would be in compliance with G20 agreements (*Department of the Treasury 2009a*, p. 88). They stressed the need for international consistency in CRA oversight – meaning that alternatives to the US regime were generally unwelcome.

In the case of CRAs, the UK followed the line set out by big continental EU member states, eventually agreeing to independent EU rules. At the same time, the FSA warned that adaptations of the rating regime itself would not banish pro-cyclicality; changes to accounting standards and calculations of bank capital were more likely to achieve the desired results. Interestingly, this position reflects a deeper concern about the underlying self-reflexivity of ratings and the attendant limits to reforms in this area than other governments had admitted to. As was true for accounting standards, the UK position appeared more principled in this respect than the other three.

France and Germany, finally, took rather similar positions again, which have largely been incorporated into the EU legislation in the field. Sarkozy (2009), in a joint press conference with Merkel, emphasized CRA failures as a root cause of the crisis. The list of demands was in principle consistent with what other countries had asked for: addressing conflicts of interest and more transparency on methodologies, conduct and performance (cf. *Fillon 2009; Lagarde 2009b*).

Two aspects of regulatory reform initiatives surrounding CRAs stand out when they are compared to those in accounting and capital adequacy rules. First, new rules were forthcoming much more quickly, and governments have been willing to embark on legislative reform on their own instead of waiting for global agreement to emerge. As an industry, CRAs are much less relevant (and politically powerful) than banks, stock exchanges and other financial firms. That made them easy targets (*Sinclair* 2010), even if again reforms by and large missed the more fundamental problems about the role of credit ratings in reflexive markets. Second, in global reform debates competitive issues played no role, given that the credit rating industry is largely domiciled in the US and was governed by US rules. In Europe, there were no established industry interests that could impede reform. Hence CRA regulation generated limited collective action problems, and EU governments were free to pursue their own policy preferences.

4.4 Credit derivatives

Over-the-counter credit derivatives, in particular collateralized debt-obligations (CDOs) re-packaging and –tranching mortgages and credit default swaps, have been vilified as the toxic waste contaminating banks' balance sheets (see *Mügge* 2010a). Most criticisms have concentrated on the intransparency of credit derivatives, which has made it impossible for counterparties, investors, supervisors and internal risk managers to assess a financial institution's exposure. In addition, the complexity of credit derivatives has meant that, even if all information were available to all parties, the net of exposures they weave together interconnects institutions throughout the financial system too tightly. In consequence, problems at individual institutions can evolve into systemic crisis much more easily.

What have been the four countries' positions concerning regulatory responses to the systemic risks posed by unregulated markets for credit derivatives? In principle, government positions in this area are more closely aligned than in the other three cases. All identify and seek to tackle two key problems in this domain. First, they diagnose a lack of transparency in the over-the-counter (OTC) derivatives market. Neither regulators and supervisors nor market participants themselves had sufficient information to assess institutions' exposures. Second, the lack of a central counterparty made derivatives trading needlessly risky by directly exposing creditors to losses should counterparties default on their commitments. As laid out below, however, strong differences emerged over who should fill these information and infrastructure gaps and, crucially, where institutions playing such a role should be located.

Geithner (2009) clearly acknowledged that credit derivatives had been an important source of market turmoil and that therefore, they and the institutions that deal in them should fall under government regulation. In the concrete treatment he distinguished between standardized and non-standardized contracts. The former, in particular simple credit default swaps (CDS), should be traded on exchanges, much like interest rate and exchange rate derivatives (*Department of the Treasury* 2009a, 2009b). Given not only the transparency that brings, but also the enhanced security through the presence of the central counterparty, panics such as those following the collapse of Lehman Brothers and AIG might be avoided. In this light, *Geithner* advocated the greater use of standardized contracts as replacements for OTC-trades without, however, proposing specific legal instruments to spur a shift in participants' behaviour. According to US plans, non-stan-

standardized derivatives would have to be reported to trade repositories. All in all, the goal has been to increase market transparency.

Other countries had somewhat less faith in efforts to increase transparency through enhanced information provision and central clearing, not least because many OTC-derivatives have been too idiosyncratic to allow on-exchange trading (*Financial Services Authority* 2009, p. 83). Nevertheless, both the Bank of England and the FSA strongly supported the use of central counterparties where possible (*Tucker* 2009). For the (possibly substantial) remainder of credit derivatives, UK authorities proposed risk minimization through bilateral collateralization and risk-appropriate capital charges (*HM Treasury* 2009, pp. 80f).

In contrast to the regulation of CRAs, in derivatives market cross-border cooperation is essential as otherwise, traders can move contentious business to more lightly regulated jurisdictions. Hence the US put international coordination of measures central. So far, such cooperation has largely floundered on differences over where and by whom credit default swaps (CDS), the likely candidate for on-exchange trading in the world of credit derivatives, should be traded. The EU Commission proposed to have euro-denominated CDS cleared in the euro-zone, a move that unsurprisingly displeased the UK (*Financial Services Authority* 2009, p. 83) given that City-based firms would thus miss significant clearing business. In December 2008 NYSE Liffe and LCH.Clearnet had launched a CDS clearer in London, which failed to attract any business, however (*Grant/Tait* 2009a). In February of the following year, LCH.Clearnet again launched an initiative, this time on its own. To pre-empt problems stemming from restrictive EU legislation, the service was planned to be operated through Paris-based subsidiary LCH.Clearnet SA (*Grant* 2009b).

Indeed, France had been most vocal in lobbying the ECB to push for a central euro-zone counterparty for OTC derivatives (*Grant/Tait* 2009b). An earlier attempt to push through such plans had failed due to the resistance of large traders, who preferred clearing all their trades with one single (by default American) CCP in order to allow netting of positions and hence lower capital charges (*Jones* 2009). Early in 2009 EU plans did take shape, however (*EurActiv* 2009), and the European Commission set a July 2009 deadline for central clearing of CDS contracts in Europe (*Grant* 2009a).

Ever since, intra-European discussions have been shaped by governments' attempts to attract euro-derivatives clearing to their financial centres (for France, that became particularly clear through a leaked document of the Banque de France, see *Hollinger/Daneshkhu* 2009). Deutsche Börse launched a central clearing service (Eurex Clearing) in July 2009 (*Tait/Grant* 2009), now competing head-on with Clearnet in France and the US Intercontinental Exchange (*Grant/Tait* 2009a; *Weitzman* 2009). Agreement on European rules that might decide the race among these is still being drafted in the summer of 2010 (*Clark/Cameron* 2010).

Unsurprisingly, US authorities saw little need for European public authorities to channel clearing business to any particular clearing house (*Beary* 2009), suspecting that without specific rules, much business would gravitate towards US clearers and thus come under their purview. As Jouvett, head of the French regulator, pointed out in July 2009, precisely that might be the result of the intra-European stalemate (*Hollinger/Daneshkhu* 2009).

In the case of credit derivatives, the competitive interests of firms who contend for potential future clearing business is even clearer than in the other cases discussed, given the concentration in the sector. Protagonists in this debate make few pretences to prudential considerations underlying their positions. In contrast to for example banking services, business gravitates to central platforms. Once a central clearer has been established, expe-

rience shows that competition is very limited. Hence, the challenge from the perspective of public authorities is not to fine-tune a playing field but to give their own champion a regulatory head start. Arcane rules matter less than a simple mandating of where clearing may and may not take place. In this way, the industry structure fostered an unusually blunt international debate.

5. Conclusion: comparing reforms across policy-domains

How do reform measures, proposals and debates compare across the four domains discussed? How much explanatory power do the factors outlined at the beginning of this paper have? And how far have reform positions departed from previous regulatory orthodoxy? Across all domains, reform proposals have been timid compared to the critical analyses of pre-crisis regulation and financial markets that have been tabled. Virtually none of the proposals have put forward serious alternatives to the market-mechanism as the cornerstone of regulatory practice. To be fair, in three of the four domains, there are few alternatives to draw on. Thus even though fair-value accounting has drawn much criticism, it remains unclear what a viable replacement would be. The most obvious alternative is a reversion to the use of book-values for securities. But unless such a shift were pursued wholeheartedly, it would generate inconsistencies even within banks' individual balance sheets, not to mention enormous possibilities for accounting arbitrage, as it would then probably become known. At the very least, the selective use of book value and market value for securities would unmask the misleading pretence of accounting standards that they could provide objective measures of value. That would be honest enough, but thus far, even the critics of mark-to-market accounting have refused to withdraw support for FVA.

Similarly, regulators and supervisors agree that banks' capital charges need to reflect systemic risks. Proposals to build macro-prudential elements into capital charges are sensible in this respect, but again, it remains unclear how this could be done without shattering the illusion that at least parts of financial systems could function without overt public intervention. After all, just when an up-swing would end (and hence capital requirements would have to be relaxed) would be for supervisors to decide, and given market reflexivity, there is no obvious indicator on which they could rely. Given the economic importance of credit provision, the identification of such turning points will inevitably be politicized and with it the governance of the banking sector itself. Again, policymakers thus far refuse to spell out the concrete consequences of abstract ideas about the internalization of systemic risk in individual banks' capital charges.

Also the discussion about CRAs has, seen in this light, concentrated on issues that are marginal to the endogeneity of ratings. One proposal that falls outside this category, however, is the simple suggestion to oblige CRAs to rate only those products for which reliable methodologies exist. With such a step, complex credit derivatives would simply remain unrated – which makes sense given the inherent unpredictability of their value and potential losses. More importantly, it would be a regulatory admission that for some securities, we can calculate default probabilities within an acceptable margin of error, and for others, we cannot. Needless to say, if such reasoning were accepted in the world of CRAs, it would put banking regulators under serious pressure to explain why, if CRAs cannot rate for example CDOs, banks should be expected to do better.

OTC derivatives, finally, remain an issue policymakers view with considerable circumspection. Given that infinite varieties are thinkable, and that the distinction between ‘good’ and ‘bad’ derivatives is difficult, if not impossible, to make (*Bryan/Rafferty* 2005; *Mügge* 2009), the outright prohibition of particular OTC products is hardly considered. Instead, proposals rely on measures to increase transparency, capital charges, market liquidity and insurance through central counterparties.

The availability of regulatory alternatives has thus limited the reform proposals that governments have been able to put on the table. What has been most remarkable in the differences of opinion between them, however, has been government willingness to defend the competitive interests of national financial industries. Save in the case of credit rating agencies, where the concentration of firms in the US made competitive struggles a non-issue, government positions have neatly traced the regulatory preferences of national firms. What mattered here was not so much the absolute level of profits they could earn, but firms’ market position relative to foreign competitors – summed up in concerns about ‘level playing fields’. This has been true not only for banks, as shown in the accounting standards and capital adequacy rules-cases, but also for clearers, as evidenced in the case of derivatives regulation. However much may change in the regulation of the financial sectors – rule setting remains a game dominated by insider interests.

Notes

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- 2 Hedge funds are an additional target of much post-crisis debate and regulation that is, however, omitted here. *Quaglia* (2009) has aptly sketched post-crisis reform politics in this domain. The overall dynamic is consistent with our finding that the interests of national firms – to the degree that a national hedge fund industry exists – continue to figure prominently in individual governments’ positions.[0] At the same time, hedge funds have been much less central to the unfolding of the credit crisis itself than the other four issue areas discussed here.
- 3 It should be noted that this research was not done for the Dutch Scientific Council for Government Policy, nor should the views expressed in this article in any way be attributed to this organisation.

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