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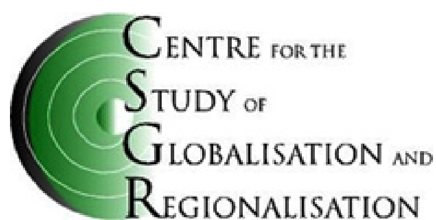

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Transnational policy communities and financial governance: the role of private actors in derivatives regulation

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Abstract

The article starts from the premise that the traditionally public functions of regulation and supervision are changing in order to adequately deal with large financial institutions operating in increasingly transnational markets. The analysis highlights the gaps left by existing public arrangements and establishes that as a result, the private sector has assumed a significant degree of authority. The article shows that private initiatives have been successful in setting best practice standards and promoting monitored self-regulation and market-based supervision. It explains how and why private groups acquire a decision-making and implementation role and furthermore, explores the issues of authority and legitimacy that follow. The article illustrates these points by focusing on the Group of Thirty, one such private organisation that has exerted considerable influence. More specifically, the analysis traces the policy influence of this group on the regulatory and supervisory framework of over-the-counter derivatives. Finally, the article shifts the attention to some of the implications of private sector involvement in policy and the potential risks to systemic stability.

Keywords: derivatives, financial governance, Group of Thirty, non-state actors, private authority, transnational policy community

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I. Introduction

Recent trends of financial liberalisation and innovation have resulted in financial institutions and the markets in which they operate becoming increasingly transnational. This is problematic for public authorities, as most regulatory and supervisory provisions remain national. Important steps have been taken to remedy this, most notably in the context of the Basle process. At the same time, however, some private non-state actors are also defining the structure of the financial system. These are individual institutions, business organisations, research institutes or hybrid groupings with characteristics from all of the above.

It is this aspect of governance in the financial markets that is at the centre of this analysis. This article argues that in the emerging multi-level/multi-actor governance process, private actors assume a growing role. It maintains that the more transnational the activity, the less likely the industry is to rely on traditional forms of regulation and supervision. It explains that the transnational character of financial markets, coupled with the volumes of transactions and the technical issues involved, lead to active private sector involvement in decision-making and the development of settings that facilitate good understanding and often agreement among public officials and practitioners. The analysis spells out how private actors acquire policy-making functions and achieve legitimacy, often on the basis of their expertise and more controversially, economic strength. Industry self-regulation and increasingly, market-based supervision are widely accepted and so, to a great extent, the private sector is writing its own script. This is significant; in influencing standards and practices, the private for profit sector is affecting public policy priorities as well.

The article illustrates these themes by focusing on the work of the Group of Thirty (G-30), a private sector organisation with considerable influence in the outcome of some of the regulatory debates of the past two decades. The G-30 is indicative of developments in financial governance and an example of formalized interaction between the public and private sectors. It brings together high-level officials from the largest financial institutions, central banks and international organisations. These individuals represent a transnational policy community of experts who, whether in the public or the private sector, are actively promoting neoliberal economic principles. The group is at the forefront of self-regulation and hence associated with private interest. Yet it is also a home for officials with strong public sector credentials and has produced high quality studies based on extensive research. The G-30 can

be positioned halfway between an interest group and a think tank and showcases the trend towards growing private authority in a field with important public policy implications.

The analysis starts with an overview of the financial system and the difficulties arising from the transnational character of financial markets. It follows with a presentation of the G-30, and evaluates the group's membership and research output. The article then explores the 'why and how' of non-state actor influence, and proceeds with an empirical investigation of the position of non-state actors in the governance structure, focusing on the work of the G-30 on the subject of over-the-counter (OTC) derivatives. Finally, some of the implications of private authority for financial stability and public policy are reviewed.

II. Transnational markets and national regulation and supervision: understanding the realities of the financial system

This article stems from the premise that financial institutions and the markets in which they operate have become transnational while regulation and supervision remain predominantly national. Important developments in international coordination have taken place in order to fill these gaps, especially efforts by national regulators and supervisors to promote stability in the banking sector through the Basle Committee for Banking Supervision (Basle Committee) and, more recently, the securities industry through the International Organisation of Securities Commissions (IOSCO). Nevertheless, a look at the way the financial system currently operates shows that the more transnational the activity, the less it is likely to rely on traditional forms of regulation (that is, nationally based and public), thus giving way to self-regulatory practices. Considering that financial markets have become transnational faster than other areas in the economy, there is a strong impetus for self-regulation (Coleman, 1994).

The transnationalisation of financial markets was sparked by liberalisation and innovation (Kaufman, 2000). It has been accompanied by the 'americanisation' of practices, with the positive competitive elements that this entails but also, with 'a built-in tendency toward excesses' (Kaufman, 2000: 127). These developments have led to institutions expressing a preference for a non-interventionist environment and often dictating one. Such a framework is in line with traditional procedures in the United States and Britain where self-regulation has long been prevalent (Moran, 1991), but less so with systems of 'institutional capitalism'

(Streeck, 1997). The trend has been overarching, however, especially as it was promoted against a background of enthusiasm for neoliberal economic principles (Helleiner, 1994).

The resulting financial environment is a result of transformations in both states and markets. With the opening up of markets, financial institutions were able to pursue the goal of minimal regulatory interference by exploiting regulatory gaps in the system. States adapted to these circumstances and acted accordingly, giving rise to what Cerny has termed the 'competition state' (1993). Liberalisation thus turned into a competitive tool for states eager to attract investment (Moran, 1991); while trying to avoid a 'race to the bottom', officials are keen to keep the bureaucratic process to a minimum and assure flexibility. The private sector is also taking a leading policy role on the basis of its expertise. Regulators are often behind industry practices with regards to technical knowledge and innovation. Finally, an authority shift is made possible by the reputation of 'finance' as complicated and technical; financial issues tend to attract limited attention (Helleiner, 1994: 19). While other aspects of globalisation have caused some concern among constituents, specific financial policies have mostly remained out of the limelight.

As a result, self-regulation is taking place. This is manifested in two sets of developments. The first is an emphasis on standards rather than rules; 'one rule cannot fit all cases' and intrusive regulation can be too costly (Goodhart et al., 1998: 46, 50). The industry, including organisations such as the G-30, actively promotes 'best practice' standards. The main challenge is for the private sector to provide these responsibly and consistently. The second development is that the advance of self-regulation in turn leaves public authorities in charge of market-based supervision. As the latest Basle Committee proposals for capital adequacy requirements demonstrate, supervision increasingly relies on transparency and disclosure, as well as the competence of internal models for the calculation of risk (Basle Committee, 2001). Models, of course, come with assumptions and limitations and are only as good as the people who operate them. They are, however, complemented by more informal means of market discipline. The financial institutions large enough to cause potential concern to supervisors are few in number and tend to be located in specific financial centres. This encourages flows of information, gossip and employees, and allows institutions to know a fair amount about each other's activities. Other market actors such as rating agencies and equity analysts also monitor practices. In addition, the failure or near-failure of an institution can be a strong market incentive for banks to act more responsibly. That activities are

increasingly concentrated among a small cluster of financial institutions that have developed sizeable exposures to each other does cause some concern, however, as this degree of interconnectedness could be a source of systemic risk. This makes proper practice vital and highlights the 'leap of faith' involved in the acceptance of self-regulation and market-based supervision.

III. The Group of Thirty: a presentation[1]

The G-30 is an organisation that has taken on governance functions in the current financial system and is the product of the confused regulatory and supervisory environment following years of liberalisation, transnationalisation and increases in the volume of capital flows. Its formal name is 'Consultative Group on International Economic and Monetary Affairs'. Founded in 1978 with the support of the Rockefeller Foundation, the group aims to 'deepen the understanding of international economic and financial issues, to explore the international repercussions of decision taken in the public and private sectors, and to examine the choices available to market practitioners and policy makers' (G-30, 1998: 3). But what does this mean, exactly? Financial journalists have portrayed the group as a private club, a think tank, an industry group or all of the above.[2] The G-30 is more than a private members' club. It produces high calibre studies but does not have the research capabilities and perceived independence of a think tank. It is a private sector group but its membership includes personalities outside the private sector and most importantly, is made up of people, and not banks and firms.[3] The G-30 is an organisation that defies traditional distinctions of public, private and academic; it is a hybrid, a group that has been at the forefront of some of the battles won by the private sector, while retaining a reputation for responsible work.

The G-30 is comprised of thirty members at any one time, individuals with strong credentials in the fields of economics and finance. The Appendix provides a list of current members, and information on their educational and professional backgrounds. The list is impressive: the group brings together high profile people from international institutions, national supervisory agencies and major banks, along with prominent academic economists. The group is a meeting ground for individuals who are currently responsible for the activities within, and the supervision of, financial markets. The G-30 is a group of people who often interact in their professional lives, in meetings of supervisors or in conferences and symposia of private associations. Furthermore, they are often members of other private organisations. G-30

members have gone through a specific educational and professional process and their paths cross on many occasions. There are significant implications of this membership pattern for the group's policy preferences. Both the group and its members are part of a transnational policy community in principle favourable to neoliberalism and global financial integration.

The G-30 meets twice a year. Meetings include a general discussion on current issues and examine ongoing work and new proposals. This is where study topics are chosen and decisions taken on future reports. There are three types of published material. First in importance and exposure are the reports, prepared by special experts and rigorous exercises of research. The group also publishes a series of occasional papers and has established a series of lectures on major financial topics.[4] Study group reports covered very ambitious topics in the early days of the group, ranging from exchange rates to the energy situation. In the late 1980s, however, the group's efforts turned to finance, and its work became more specialized and practical, dealing with issues such as clearance and settlement in the securities markets and OTC derivatives. The G-30 concerned itself with the 'plumbing and wiring' of the financial system and found that its ability to provide expert recommendations on technical issues put it at the forefront of (self-) regulatory and supervisory initiatives.

IV. Non-state actors in the financial markets: understanding private influence and authority

The process of the weakening of state authority is well documented; 'where states were once the masters of markets, now it is the markets which, on many crucial issues, are the masters over the governments of states' (Strange, 1996: 4). In order to conceptualise authority, we are urged to differentiate between government and governance and incorporate a wider variety of actors, including non-state entities (Rosenau, 1992). The concept of 'spheres of authority' is also valuable, separating governance from territorial boundaries and allowing for an understanding of authority within a sector (Rosenau, 1997). Authority is not related to the public arena, but to legitimacy (Friedman, 1990). Cutler et al. maintain that 'private authority can … evoke a sense of legitimacy and achieve a high degree of acceptance through recognition by others of specific knowledge, expertise, and representational skills' (Cutler et al., 1999: 18).

This is not a new phenomenon. Many national economies were organized according to corporatist principles, which brought together the state, business and labour. Delegation of authority to these groups took the form of 'private interest government' (Streeck and Schmitter, 1985). What we experience today is an altered version of corporatism, with labour out of the equation and with increased emphasis on the international/transnational dimension. 'A new axis of influence linked international policy networks with the key central agencies of government and with big business' (Cox, 1996: 109).

The private sector is involved in financial policy processes through its active and dominant presence in a developing and coherent transnational policy community within which debates and decision-making about the structure, regulation and supervision of financial activities and institutions are taking place. This community has at its core organisations such as the G-30, which bring together relevant public officials and senior financiers. It provides more or less formal settings for these individuals to reach common ground on the general and the specific of financial architecture. It essentially facilitates the interaction of elites who have strong connections with the main economic players and are often the product of a similar educational, social and ideological upbringing (Gill, 1990; van der Pijl, 1998). On this basis, and in the context of the practice of 'revolving doors' whereby most officials' careers include high-level positions in both the public and the private sector, this public-private distinction becomes blurred. Instead, influence over policy-making is based on expertise, which can render the regulatory process 'captive of knowledge specialists' (Lindblom, 1977: 120). The significance of expertise is explored in the concept of 'epistemic communities', which focuses on knowledge in a particular 'issue-area' and emphasizes that complexity and uncertainty create conditions that are favourable to the prominence of policy communities (Haas, 1992). In this configuration, the private sector has an advantage in its capacity as knowledge holder and can thus claim a great degree of authority over technical issues and eventually establish its position of strength on policy decisions of wider scope and implications. A technocratic framework, however, is not interest-free and knowledge and expertise can determine which actors and which ideas are included or excluded in the making of policy (Strange, 1994). The weight of knowledge in decision-making has served to de-politicise certain financial issues (Radaelli, 1995), thus taking some potentially controversial questions outside the public arena. Moreover, the transnational nature of policy communities encourages policy convergence (Stone, 2001), which in turn offers legitimacy. This is important; the transnational policy community as a whole and the G-30 in particular have in

recent years presented neoliberal economic principles as the only path to long-term stability, efficiency, growth and development. Economic ideas are not innocent (Jacobsen, 1995). Group such as the G-30 have not only legitimised private sector involvement in policy-making but have also enabled private interest to be internalised in financial policy decisions.

The sources of influence for non-state actors have been identified as 'mass membership or support', 'professional standing and expertise', 'financial strength', 'employment generating capacity' and 'access to international institutions and national governments' (Josselin and Wallace, 2001: 253). Private actors operating in the financial markets might base their authority on a combination of some of the above. The influence of the G-30 stems from the expertise of members and study group participants. Moreover, G-30 initiatives have the backing of the private sector and thus, carry financial clout. Finally, the G-30 has considerable access to policy-makers: many of its members are the target audience and the group is an example of formalized and regular public-private sector interaction.

Groups such as the G-30 channel their influence in several ways. They can exert 'atmospheric influence', influence the 'medium- or short-term agenda', or affect 'micro-policy research'. Means of influence include the public and private approaches (James, 2000). G-30 work has shaped specific policy outcomes but has also influenced financial policy in general by shifting authority to the private sector. This was achieved through the use of public reports but also, with the support of informal and unofficial networking provided by the group's high profile members.

V. The role and influence of the Group of Thirty: an empirical examination

The G-30 has produced several influential studies that have shaped practices in a particular area of financial activity. For the purposes of this article, this section focuses on one such study, the group's work on OTC derivatives. A derivative is 'a contract or security whose value is closely related to and to a large extent determined by the value of a related security, commodity, or index'. When OTC, it is also 'a financial transaction that is not made on an organized exchange. Generally the parties must negotiate all the details themselves or agree to use simplifying market conventions' (Steinherr, 1998: 395, 401). Derivatives are long established instruments for hedging against potential risk. Their importance for the financial

system, however, has changed in recent years. Firstly, there is a difference of degree: the volumes in derivatives trading are tremendous, reaching $128 trillion in June 2002 (Bank for International Settlements, 2002). More importantly, it is a difference in kind: derivatives have developed into increasingly sophisticated and customized instruments.

In the early 1990s, public authorities, but many in the private sector too, were looking for direction in dealing with derivatives. The G-30 study, published in 1993, was the first to address OTC derivatives and thus became the primary consultative document for regulators, supervisors and practitioners. The report's resonance was based on several factors: its timing was beneficial as it coincided with the early stages of the regulatory debate on derivatives; its recommendations were welcomed for their high quality and reliance on technical knowledge and expertise; finally, both the public and private sector cared a great deal about the subject. The significance of the G-30 initiative for the industry became quickly clear. The study was sufficiently established and accepted by regulators and supervisors for the industry to successfully withstand calls for a severe strengthening of the regulatory framework in the aftermath of well-publicized losses and mishandling of OTC derivatives.

The G-30 study: explanations and recommendations

Derivatives: Practices and Principles (G-30, 1993) makes three major points about derivatives. Firstly, it emphasizes that OTC derivatives are useful to the financial system as they provide 'new ways to understand, measure and manage financial risk'. Secondly, the study promotes the idea that derivatives should not be differentiated from other instruments and that they do not require special treatment. Thirdly, the report stresses that responsible and efficient self-regulation is key to the use of derivatives, and that intrusive rules-based regulation would render these instruments rigid and hamper financial innovation. This means that standards are the answer, not specific regulation or legislation.

The study puts forward twenty-four recommendations, most directed at dealers and end-users. The recommendations cover the main types of risk, proposing risk management procedures accordingly. The primary recommendation to practitioners refers to the role of senior management (R. 1). This policy is aimed at ensuring that management has adequate understanding of the instruments and that it is aware of the consequences of their use. The report also insists on independent risk management (R. 8, 12) which would allow financial institutions to have clear lines of responsibility and authority on risk matters, and assure the

separation of front and back office. In addition, the study promotes professional expertise (R. 16). The use of derivatives is also to be made safer and more efficient with the development of advanced systems (R. 17); individual institutions are expected to improve their information technology capabilities according to their involvement with derivatives. Finally, the study concentrates on the issue of disclosure (R. 20). In order to enhance responsible self-regulation, financial firms are to provide additional qualitative information on the use of derivatives and the management of subsequent risks in their statements. The study also provides some recommendations for regulators and legislators. These amount to recognising netting, assisting in the removal of legal and regulatory uncertainties, supply a favourable tax treatment of derivatives, and working on setting international accounting standards (R. 21-24).

These recommendations were based on extensive surveys, primarily of private sector practitioners. The effort was mostly privately financed and an initiative of J.P. Morgan, who took the decision to publicize its model for measuring market risk free of charge; RiskMetrics, became available to banks and securities firms as part of the overall G-30 effort. The recommendations also came with supporting documentation on practices and the legal enforceability of derivatives contracts in different jurisdictions.

The aftermath of the study: public and private sector responses

The G-30 report made an impact. The response of regulators was positive and during a seminar organized by the G-30 a few months after publication, officials had the opportunity to voice high praise for the recommendations put forward. One problem was identified, however, relating to the question of systemic risk. Quinn, then Executive Director at the Bank of England, was impressed by the study, but hit the mark – and some raw nerves - with his point that the G-30 assertion that the supervisory framework was adequate as it stood was ‘somehow complacent’ (Quinn, 1993: 536). He argued that knowledge of derivatives remained partial and that practitioners and public officials alike were still both excited and alarmed by the instruments. As subsequent analysis shows, this factor did not prevent widespread acceptance of the study.

The G-30 shifted its focus back to the private sector and concluded its series on derivatives with a follow-up survey of practice among dealers and end-users where it appears that the industry responded well to the recommendations. Practitioners had taken notice of the

proposals and adapted their practices accordingly (G-30, 1994a). The survey shows significant implementation since the publication of the study, with fifty-eight percent of those surveyed saying that the firm's policies were benchmarked against G-30 recommendations (G-30, 1994a: 5). That the private sector was fast in acting upon the report's recommendations is a testament to the credibility of the exercise. Best practice quickly became the base and institutions were encouraged to go further.

The reception of the G-30 study: an assessment of reactions outside G-30 sponsorship

The G-30 study was noticed and its contents amply discussed, giving the G-30 an influential role in the debate. Following publication, numerous articles were produced on the study, often outlining and analysing specific recommendations (Chew, 1993: 6-7). The G-30 did not fool anyone about its true intentions; it was widely acknowledged that it had acted to prevent regulatory involvement. However, it was accepted that it had done a good job and noted that supervisors welcomed the initiative.

For good reason. The press emphasized the issue of expertise. In one article, the authority of the study is mirrored in the title 'The 24 Commandments of the G-30' with the author wondering whether 'anyone apart from participants themselves understand this market well enough' (Corporate Finance, 1993: 37, 42). Press commentators agreed that the proposals showed that financial firms were not resting on their laurels and had produced high standards (Wall Street Journal, 1993). Moreover, analysis focused on the positive response of market participants, shown to be prepared to implement the recommendations (Euroweek, 1993: 3).

In this context, one article concluded that the report 'answers some, if not the most important, of the criticisms of derivatives' (Economist, 1993: 14). Some issues did, indeed, remain. One was that of compliance; the G-30 did not have the authority to impose the standards. 'Powerful its membership may be, but it cannot force anyone to implement its best market practices: at best, it can influence regulatory thinking' (Chew, 1993: 6). In addition, the question of systemic risk was reiterated; for some, a better discussion would have been welcome (Economist, 1993: 15). Others, however, were persuaded by the G-30 conclusion that risks associated with derivatives are not different in nature to those of other financial instruments (Corporate Finance, 1993: 41-42). In any case, it appears that these voiced shortcomings did not hamper the report's main conclusions on self-regulation. As the

following sections confirm, the G-30 recommendations were widely adopted, and the report treated as the ‘official handbook’ on derivatives.

Assessing the study’s influence – The treatment of OTC derivatives by international organisations

The G-30 study was essentially the first of many on the subject of OTC derivatives. It affected the policy discussion and made responsible self-regulation the focal point. The G-30 promoted its conclusions by addressing its audience, part of which was already within the G-30 community (either as members, study group participants or invited guests). The G-30 also relied on the existing understanding among public and private sector officials in the financial markets to get its message across. Furthermore, the timing of the study meant that the work of the group was sought at a time of uncertainty. In this context, and judging from the positive response that it received, it is hardly surprising to see its recommendations replicated in the studies of major international organisations. Dealing specifically with this topic, two important reports were made public a year after the work of the G-30 was put forward, produced by the Basle Committee and the Technical Committee of IOSCO. They closely followed the recommendations of the G-30 and based their findings on consultation with the public and the private sector, the latter also responsible for providing information for the G-30 study. These reports emphasized that they were issuing guidelines based on the practices of major institutions (Basle Committee, 1994: 1) rather than ‘normative standards’ (IOSCO, 1994: 72), and their guidance followed the G-30 lead on issues such as the role and responsibilities of senior management, the importance of having a concerted derivatives strategy, managed by independent risk-management units and the question of risk measurement. In both reports, regulators and supervisors showed reluctance to interfere in the derivatives markets, offering a hands-off stance and focusing on industry standards (Basle Committee, 1994 and IOSCO, 1994). This self-regulatory approach has been carried through in subsequent reports by these organisations.

Assessing the influence of the G-30 study: self-regulation in the US context

Further evidence of the success of the G-30 study is to be found in the outcome of the regulatory debate in the United States. Not only did the study form the basis of the reports produced by the various regulatory agencies but also, it took centre stage during congressional hearings and was instrumental in offsetting legislation. The G-30 effort became a focal point of what appeared like an increasingly like-minded policy community comprised

of a coalition of private and public actors, financial institutions and regulatory and supervisory agencies and central banks. As shaped in the US, the debate on OTC derivatives took place between a policy community favourable to self-regulation on the one hand, the legislators, supported by the ‘dangerous’ public image that derivative instruments developed in the aftermath of the publication of the G-30 study on the other.

The Fed’s approval of the G-30 effort and its lack of interest in more dynamic intervention can be seen in the guidelines issued on the topic of derivatives. The Fed report effectively picked up the principal G-30 recommendations on the role of senior management, independent risk-management units, risk measurement, breakdown in categories of risk, and adequate reporting (Board of Directors of the Federal Reserve System, 1993). The other agencies followed a similar direction. In its report, the Office of the Comptroller of the Currency (OCC) emphasized the importance of senior management and appeared confident with existing regulatory arrangements (OCC, 1993). Likewise, the Commodity Futures Trading Commission (CFTC) acknowledged the work of the G-30 and offered a discussion of risks that mirrors that of the G-30 report, providing direct references to its recommendations (CFTC, 1993: 191-201). Furthermore, the CFTC affirmed that ‘no fundamental changes in regulatory structure appear to be needed’ (CFTC, 1993: 159).

A dissenting voice did emerge, however, in the form of the General Accounting Office (GAO) report to Congress. This report relied heavily on the G-30 study and its data, and its conclusions mirrored those of the G-30 on the role of senior management, as well as on the specifics of managing different types of risk (GAO, 1994). Yet it held that recommendations were not sufficient as the G-30, just like federal regulators’ guidance, did not have the ‘weight’ of actual regulation (GAO, 1994). As a result, the report advocated further regulation and possibly legislation.

There was indeed reason to suspect that the argument for increased and derivatives-specific regulation could gain support. The year 1994 was especially bad for the reputation of OTC derivatives, with some high profile losses hitting the headlines. Financial institutions were portrayed as irresponsible and risk-taking and the public perception of derivatives suffered. Three cases in particular highlighted all that can go wrong when the instruments are used unwisely: they involved Gibson Greetings and Bankers Trust, Proctor & Gamble (P&G) and also Bankers Trust, and Orange County and Merrill Lynch.

Bankers Trust became involved in derivatives activity early and with great success, attracting highly qualified people who could create and trade in increasingly complex products. In 1991, the bank started dealings with Gibson Greetings of Cincinnati, the second biggest US greeting card manufacturer. The first two derivative contracts arranged with the firm were plain vanilla deals that were profitable but subsequent deals performed less well, going beyond the $3 million limit set by Gibson. Bankers Trust lied about the losses, which ultimately amounted to $27.5 million. The case was investigated by the SEC and CFTC, which determined that Bakers Trust had lied to its client. Eventually, Bankers Trust settled with Gibson, paid a large fine and parted with several employees (Thomson, 1998, Washington Post, 1995a)

P&G, arguably a more sophisticated player, did not fare a lot better in its dealings with Bankers Trust. The company agreed deals with major loss potential in 1993 and 1994, which did indeed result in losses of $160 million. This was a source of great embarrassment to the treasury department of P&G but telephone conversations indicate that Bankers Trust officials were aware that P&G did not fully understand the risks involved: ‘It’s like Russian roulette, and I keep putting another bullet in the revolver each time I do one of these [trades]’ said one Banker Trust salesman. P&G launched litigation against Bankers Trust and an out-of-court settlement was finally agreed. Bankers Trust did not come out of these dealings unscathed; it suffered large losses but eventually survived (Thomson, 1998, Washington Post, 1995b).

Orange County, a traditionally Republican group of municipalities in California, also found itself in an unenviable position after dealing with OTC derivatives. The county treasurer, aiming to balance conflicting citizens’ expectations of lowering taxes and maintaining or increasing services, became more adventurous with the county’s investment fund, pursuing an aggressive and complex strategy. Merrill Lynch sold many of the products that contributed to losses of over $1.5 billion in 1994. This time, however, the fault lay mostly with the end-user. A California state special committee report found that the county’s strategy was knowingly risky and put much of the blame on the county’s practices (Wall Street Journal, 1994, 1995).

In this context, different dynamics converged in Congress, where the hardest battle was fought, and won, by those favouring self-regulation. The financial policy community brought its knowledge and influential position to the table and stuck together through the common

belief in self-regulation as promoted by the G-30 recommendations. Legislators pushed for stricter regulations in the light of losses and the low public confidence in the industry behaving itself. What follows is the chronicle of the debate as it unfolded in the context of congressional hearings in the House of Representatives (HoR).

The first round of congressional hearings took place a few months after the publication of the G-30 study. Essentially, it provided an opportunity for the regulatory agencies to present their own reports (which had relied specifically on the work of the G-30) and for all concerned to take a position in the debate on derivatives. Agency representatives from the OCC, the Fed and the CFTC outlined their recommendations, overwhelmingly promoting best practice standards as opposed to rules-based regulation. The G-30 was also represented during the hearings by study group participant Brickel, who in his statement reiterated that the group produced 'the best standards we could find'. 'We set the hurdle high' (HoR, 1994a: 568-571). James Leach, the House Representative who initiated the hearings agreed that the G-30 had put forward a study that was 'constructive and helpful' and praised the group, and J.P. Morgan, for taking the initiative to show best practice at the highest level (HoR, 1994a: 29-30). Nevertheless, he was adamant that this was just one side of the process and that there should be a more concrete regulatory framework.

Further indication of the influence of the G-30 study can be seen in the supporting material to the hearings. One volume put together all relevant documents on the subject of derivatives; the G-30 study is the first report on offer (HoR, 1994a: 1177-1195). More importantly, the second volume reveals that regulatory agencies had been asked to comment specifically on the recommendations of the G-30 report. Their response was clear; agencies held that G-30 recommendations 'contribute to a better understanding of sound risk management and accounting practices, and to the extent that they are adopted by institutions, should help to strengthen the management and operating practices of individual institutions and the financial system as a whole' (HoR, 1994a: 121). The question of compliance did not appear to worry either: 'Regulators have seen evidence that market participants are currently assessing their compliance with the recommendations, and, with the encouragement from regulators, will work toward implementing the recommendations where appropriate' (HoR, 1994a: 134). Even when reviewing individual recommendations, no real concern was voiced by the agencies with any of them (HoR, 1994a: 122-125). The conclusion that supervisory guidance was sufficient ensued (HoR, 1994a: 121).

In the second round of hearings, Congress had some concrete proposals of its own, and tried to push its case for a stricter regulatory environment in the form of H.R. 4503, The Derivatives Safety and Soundness Supervision Act of 1994. Nonetheless, regulatory agencies once again denied that legislation was necessary, and did so quite forcefully. The Comptroller of the Currency stated that 'H.R.4503 is a thoughtful response to these issues'. 'The OCC does not believe, however, that legislation applying to national banks in the derivatives area is necessary at this time' (HoR, 1994b: 62). Representatives of the FDIC and the Office of Thrift Supervision were of the same opinion (HoR, 1994b: 84, 87). The final seal of disapproval came from Greenspan: 'we do not believe that legislation in this area is necessary at this time' (HoR, 1994b: 146).

At this stage, the private sector was also invited to provide input. Not surprisingly, its representatives were similarly hostile to legislation. In their defence, they once again used the G-30 study. Logan, speaking on behalf of the American Bankers Association, brought up the guidelines produced by regulatory agencies and indicated that they were a direct follow-up to the G-30 study. He also maintained that G-30 recommendations were being implemented and were on the way to becoming standard industry practice (HoR, 1994b: 118).

In the end, the committee's attempts at legislation fell through. There was another congressional push that sought to gain support for a bill on the basis of the above-reviewed important and well-documented derivatives losses, however, it did not capitalize.[5] Derivatives were not treated to separate and restrictive legislation and the idea of self-regulation became more established.

So what happened? The House committee strongly attacked derivatives. One of the bill's sponsors, Representative Gonzalez, often used the word 'casino' in his references to derivatives. More generally, congressmen were particularly worried that they would be accused of inaction should a derivatives disaster strike, and were convinced that it would (Peltz, 1994: 100). But legislation was never going to be easy as it is in itself a lengthy process.

The willingness of regulatory agencies to accept best practice standards and go down the path of self-regulation does require some explanation, however. On the basis of the evidence, supervisors were impressed with the quality of the G-30 recommendations and accepted the

primacy of private sector expertise. In fact, the debate on the regulation of derivatives came at a time of 'high degree of co-ordination among US regulators and private market participants' (Levin et al., 1994: 15). Public authorities, and in particular the Fed, did not just accept self-regulation but believed in it.[6] The Fed was confident in its ability to supervise and was firmly part of the policy community favouring the promotion of standards as opposed to rules. Public authorities understood that in such a dynamic market, regulation was bound to be rigid, and were concerned about the risk of regulatory arbitrage (Peltz, 1994: 102). The argument that banks and securities firms, the main derivatives dealers and users, were already properly overseen was also used. Finally, self-regulation probably benefited from agency overcrowding in the US. Turf battles among the relevant agencies also served the self-regulation cause. Clarifying who is doing what in the regulation and supervision of financial markets is often a 'messy process'.[7]

The G-30 study and the private sector: how the recommendations translated into practice

Having succeeded in offsetting regulation and legislation, both internationally, and in the US, the study was also instrumental in helping the private sector use OTC derivatives. Firstly, the G-30 study provided immediate guidance to institutions trying to get a better grasp of derivative instruments. The study had been an expensive undertaking for an organisation of the size of the G-30. Yet the group covered the cost as the industry was looking for direction and quickly bought the reports.[8] The G-30 study was also endorsed by professional organisations. The Institute of International Finance (IIF) published a framework for disclosure based on the G-30 principles and promoted uniformity in reporting (IIF, 1994). The London Investment Banking Association (LIBA) was another organisation to issue proposals following G-30 recommendations closely and by name, including guidelines on the role of senior management and treatment of different types of risk (LIBA, 1996).

The report provoked debate and brought about practical solutions to the question of senior management responsibility. It encouraged better education and training and a clear demarcation of an institution's risk-management programme (Harvard Business Review, 1995). The impact of the G-30 study can be also seen directly in industry practice. A survey by the management consultancy Touche Ross shows that the recommendations of the G-30 were implemented by a wide variety of users (Touche Ross, 1995). Also indicative is the extent to which the G-30 study has become part of standard financial jargon; the report has its rightful place in all good handbooks and glossaries of risk-management.[9]

Finally, the G-30 was the impetus for a major private sector initiative, not only for derivatives, but self-regulation. The Derivatives Policy Group (DPG) was formed, bringing together six major dealers[10] who agreed to voluntarily set detailed standards and promote meaningful disclosure. It was the first such exercise and a direct result of the G-30.[11] The report, A Framework for Voluntary Oversight of the OTC Derivatives Activities of Securities Firm Affiliates to Promote Confidence and Stability in Financial Markets (DPG, 1995), took on the G-30 recommendations and produced a detailed structure, producing concrete guidelines of practice and disclosure. The DPG emphasized management controls and clarification of accountability, enhanced reporting and counterparty relationships. It also tackled the issue of evaluating risk in relation to capital, proposing that such calculations should be based on banks' internal models. The DPG accepted that industry self-regulation would include cooperation with regulators, including the accommodation of ad hoc requests for information. This was a responsible private sector initiative. The DPG took into account regulatory concerns and addressed them seriously. Their report was also authoritative; participants were major players, with all the necessary expertise, and their opinions mattered. In addition, having the main firms involved meant that even if less sophisticated players took longer to implement recommendations, those institutions with the greater exposures were already adhering to high quality best practice standards. This positive exercise was possible thanks to the G-30 study, which had proved that the private sector could act responsibly and had the clout to make regulators listen.

VI. The reality of self-regulation: consequences and implications

Let us now turn to some of the implications of private governance and self-regulation. Firstly, the issue of the emerging democratic deficit needs to be addressed. Some in the public sector feel strongly about organisations like the G-30 because 'however select and representative this group might be, nobody elected them to do anything' (Smalhout, 1997: 125). There is indeed a 'more general crisis of representation' (Agnew and Corbridge, 1995: 216) and financial liberalisation is forcing us to accept a 'limited democracy' (Coleman, 1996: 10). Secrecy is an issue as well; not only are many decision-makers in the financial markets unelected and unaccountable, they often operate behind close doors (Picciotto, 1996). This makes it difficult to hold the actors involved responsible for their decisions; 'market actors are neither elected nor politically accountable and may not even be citizens' (Cohen, 1999: 135). This may be a positive aspect in times of crisis when, being away from public scrutiny,

responses can be faster and less controversial (Picciotto, 1996 and Underhill, 1997). In many cases, however, it reinforces the perception of a 'black box' of globalisation.

The issue of accountability develops into something more serious when distributive effects are also taken into account. The areas that need legitimacy and accountability are those most associated with the welfare state (Scharpf, 1997) and capital mobility is indeed a threat to the welfare state (Underhill, 1995). Self-regulation is about more than the delegation of authority from the public to the private. It is often accompanied by a reorganisation of spending priorities to the detriment of the welfare state and in favour of private interest (Prakash and Hart, 1999). The question of 'winners and losers' is important and should be acknowledged.

Private authority also causes concern in so far as the state appears to increasingly identify with private interests; those in charge can establish rules that determine 'who gets to play, what are the limits on play, and often who wins' (Cutler et al., 1999: 369). The key private players are often those associated with the international economy (Cerny, 1996) and a 'privileged class of market agents' has been created (Cohen, 1999: 135). There is no escaping the fact that the private groups to which authority has been delegated represent those interests most associated with transnational liberalism and capital. This means that those whose interests do not coincide with the above will be permanently under-represented.[12]

Finally, private authority could prove quite costly. Financial stability is considered a public good (Cerny, 1993: 6), or alternatively, financial instability is seen a public bad, as it can cause widespread panics and induce contagion (Wyplosz, 1999: 159). This systemic dimension is very important: 'social costs of financial distress, notably in the form of contagious effects, can easily exceed the private costs to shareholders, managers, etc., of failing institutions' (Goodhart et al., 1998: xvii). Institutions are aware of this, especially those considered to be too-big-to-fail. The lender-of-last-resort responsibilities of most central banks mean that for most institutions, a safety net is in place (Kaufman, 2000: 208-210). It used to be that banks would be the sole beneficiaries of this. However, the rescue of the hedge fund Long-Term Capital Management in 1998, achieved with private money but Fed logistical support and initiative, can lead us to believe that there is an increasing number of institutions that matter. Could this bring about a situation of unhappy taxpayers?

VIII. Conclusions

This article has established that self-regulation in financial markets is taking place and that non-state actors are in a position to assume authority. Traditional distinctions of state and market, and public and private are becoming obsolete and in order to fully comprehend the realities of financial markets, we need to develop a more complex understanding of financial governance.

The article illustrated these points with an analysis of the G-30, an organisation that is indicative of various trends in financial markets: the new role of private organisations, the blurring of public and private distinctions and the importance of public-private interaction, the importance of elites and the significance of expertise in acquiring legitimacy. The analysis of the group's study on derivatives and its influence highlighted some of the realities of financial decision making, and indicated that self-regulation is largely based on an assembled coalition of the private sector and representatives of regulatory and supervisory agencies, a coalition which strongly backs liberalisation.

The drawbacks of financial self-regulation have so far attracted limited consideration. They deserve increased attention as financial activities have a more direct impact on economic welfare than is immediately apparent. For self-regulation to work in the long run, a framework should be created that renders these actors more accountable. This could happen within the existing context of consultation and agreement among economic and financial public authorities and private institutions. Public agencies are often independent of politics, yet patterns of accountability exist. These practices should extend to include clearer lines of action and responsibility for private actors involved in the process of policy formulation and implementation.

In conceptualising governance without government, we should also disassociate authority from an optimistic understanding of democracy. This will allow us to develop a structure in which <u>all</u> actors involved in governance, public and private, can assume a more established, and thus less hidden role. This, in turn, will potentially promote accountability.

Currently, the most useful tools at our disposal are disclosure and transparency and efforts should continue to make these more meaningful and reliable. But much is to be gained by

going even further in this direction. We need a framework that ensures efficiency and financial stability and, at the same time, limits the effects of inclusion (of private interests) and exclusion (of those interests not associated with transnational finance) in the regulatory and supervisory process.

Endnotes

[1] This section is based on Koenig (1982) and MacRae (1990). It also uses information provided in interviews with members (see references).
[2] Journals surveyed for this purpose include the ABA Banking Journal, Corporate Finance, the Financial Times, Investment Dealer's Digest and The Wall Street Journal.
[3] G-30 members do not represent specific institutions. Membership remains stable irrespective of employer changes.
[4] For a full and up-to-date list of G-30 publications, see the organisation's website, www.group30.org.
[5] There were, in both houses, three failed attempts at legislation: Derivatives Safety and Soundness Supervision Act of 1994 (House-Gonzalez/Leach Bill), Derivatives Dealers Act of 1994 (House-Makey Bill) and the Derivatives Supervision Act of 1994 (Senate-Riegle Bill).
[6] Interview with Federal Reserve official. In a separate interview, an aide to Representative Leach talked of the 'free market type attitude' of public officials.
[7] Interview with Treasury official.
[8] The revenue from the sale of the studies was substantial following publication, as can be seen in the group's annual reports (G-30, 1994b, 1995).
[9] Guides published by Risk.
[10] The participating institutions were: CS First Boston, Goldman Sachs, Lehman Brothers, Merrill Lynch, Morgan Stanley and Salomon Brothers.
[11] Interview with John Heimann, G-30 member and co-chairman of DPG.
[12] See also Porter (2001).

Appendix - G-30 Member Profile (2002)

Mr. Paul A. Volcker Chairman, Board of Trustees, G-30.
Educated at Princeton, Harvard and LSE.
Public sector: President of the Federal Reserve Bank of New York, Chairman of the Board of Governors of the Federal Reserve System. Private sector: Chase Manhattan. Academia: various.

Rt. Hon, Lord Richardson of Duntisbourne, KG Honorary Chairman, G-30.
Educated at Cambridge.
Public sector: Director/ Governor of the Bank of England. Private sector: Lloyds Bank, Schroders.

Dr. Jacob A. Frenkel Chairman of the Group of Thirty. Chairman, Merrill Lynch International, Inc.
Educated at the Hebrew Univ. of Jerusalem and the Univ. of Chicago (PhD).
Public sector: IMF, Governor of the Bank of Israel. Academia: Univ. of Chicago, Tel Aviv Univ.

Dr. Leszek Balcerowicz President, National Bank of Poland.
Educated at the Warsaw School of Economics (PhD) and St John's Univ., New York.
Public sector: Deputy Prime Minister and Mister of Finance. Academia: Warsaw School of Economics.

Mr. Geoffrey Bell Executive Secretary, G-30. President, Geoffrey Bell & Co.
Educated at LSE.
Public sector: UK Treasury. Private sector: Schroders.

Dr. Domingo Cavallo Former Minister of the Economy, Argentina.
Educated at the National Univ. of Cordoba and Harvard (PhD).
Public sector: President of the Central Bank, Minister of Foreign Affairs/Finance.

Mr. E. Gerald Corrigan Managing Director, Goldman Sachs & Co.
Educated at Fordham Univ. (PhD).
Public sector: President, Federal Reserve Bank of New York.

Mr. Andrew D. Crockett General Manager, Bank for International Settlements (outgoing).
Educated at Cambridge and Yale.
Public sector: IMF, Executive Director of the Bank of England.

Mr. Richard A. Debs Advisory Director, Morgan Stanley & Co.
Educated at Colgate Univ., Princeton (PhD) and Harvard.
Public sector: Federal Reserve Bank of New York.

Sr. Guillermo de la Dehesa President, Banco Santander Central Hispanico.
Educated at the Univ. of Madrid.
Public sector: Bank of Spain, Minister of Finance. Private sector: Goldman Sachs, Europe.

Professor Gerhard Fels Director, Insititut der deutschen Wirtschaft.
Educated at the Univ. of Saarbrücken (PhD).

Dr. Stanley Fischer President, Citigroup International.
Educated at LSE and MIT (PhD).
Public sector: First Dep. Managing Director of the IMF. Academia: Univ. of Chicago, MIT.

Mr. Arminio Fraga Neto Governor, Banco Central do Brasil.
Educated at the Catholic University of Rio de Janeiro and Princeton (PhD).
Private sector: Solomon Brothers, Soros Management Fund. Academia: Columbia, Wharton School.

Mr. Toyoo Gyohten President, Institute for International Monetary Affairs.
Educated at the Univ. of Tokyo.
Public sector: Ministry of Finance, Japan. Private sector: Bank of Tokyo.

Mr. Gerd Hausler Counsellor and Director, International Capital Markets Department, IMF.
Public sector: Deutsche Bundesbank. Private sector: Dresdner Bank.

Mr. John Heimann Senior Advisor, Merrill Lynch & Co.
Educated at Syracuse Univ.
Public sector: Comptroller of the Currency (US), Chairman of the Financial Stability Institute, Private sector: Smith, Warburg, Merrill Lynch.

Professor Peter B. Kenen Walker Professor of Economics and International Finance, Princeton.
Educated at Columbia and Harvard (PhD).
Public sector: consultancy work. Private sector: consultancy work. Academia: Columbia.

Mr. Mervyn King Deputy Governor of the Bank of England (appointed Governor, effective June 2003).
Educated at Cambridge and Harvard.
Public sector: Bank of England. Academia: Cambridge, Birmingham, LSE.

Professor Paul Krugman Professor of Economics, Woodrow Wilson School, Princeton.
Educated at MIT (PhD).
Academia: Yale, Stanford, MIT.

M. Jacques de Larosière Conseiller, Paribas.
Educated at the Institut d'études politiques and ENA.
Public sector: Managing Director of the IMF, Governor of the Bank of France, President of the EBRD.

Mr. William McDonough President, Federal Reserve Bank of New York.
Educated at Georgetown.
Public sector: US State Department, World Bank. Private sector: First National Bank of Chicago.

Mr. Shijuro Ogata Former Deputy Governor, Bank of Japan.

Educated at the Univ. of Tokyo and the Fletcher School.
Public sector: Bank of Japan.

Mr. Guillermo Ortiz Martinez Governor, Banco de Mexico.
Educated at the National Autonomous Univ. of Mexico and Stanford (PhD).
Public sector: Ministry of /Finance, Mexico, Executive Director, IMF. Academia: various.

Dr. Sylvia Ostry Distinguished Research Fellow, Centre for International Studies, Toronto.
Educated at McGill and Cambridge (PhD).
Public sector: Federal Government of Canada, OECD. Academia: various.

Dr. Tomasso Padoa-Schioppa Member of the Executive Board, European Central Bank.
Educated at Bocconi and MIT.
Public sector: Banca d'Italia, European Commission.

Mr. William R. Rhodes Senior Vice-Chairman, Citigroup.
Private sector: Citibank.

Mr. Ernest Stern Managing Director, J.P. Morgan Chase.
Educated at Queen's College and the Fletcher School (PhD).
Public sector: US Department of Commerce, USAID, World Bank.

Mr. Lawrence Summers President, Harvard University.
Educated at MIT and Harvard (PhD).
Public sector: World Bank, US Secretary of the Treasury. Academia: MIT, Harvard.

M. Jean-Claude Trichet Governeur, Banque de France.
Educated at the Ecole Polytechinque, the Institut d'études politiques and ENA.
Public sector: Ministry of Finance, Cabinet Councillor (France).

Sir David Walker Treasurer, Group of Thirty. Senior Advisor, Morgan Stanley International Inc.
Educated at Cambridge.
Public sector: Bank of England, Chairman of the SIB. Private sector: Dep. Chairman of Lloyds Bank.

Dr. Marina v N. Whitman Prof. of Business Administration and Public Policy, Univ. of Michigan.
Educated at Radcliffe College and Columbia (PhD).
Private sector: General Motors Corporation. Academia: University of Pittsburgh.

Mr. Yutaka Yamaguchi Deputy Governor, Bank of Japan.
Educated at the Univ. of Tokyo.
Public sector: Bank of Japan.

Source: Who's Who in the World, institution, company and university websites.
Titles as used by G-30. Current positions valid in December 2002.

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Bell, Geoffrey (*), President, Geoffrey Bell & Company. London, 19 January 2001.

Crockett, Andrew (*), General Manager, Bank for International Settlements. Basle, 8 February 2000.

Heimann, John (*) Chairman, Financial Stability Institute. Basle, 8 February 2000.

Kenen, Peter (*) Professor, Director of International Finance Section, Department of Economics, Princeton University. Washington, DC, 20 October 1999.

Parker, Gary, House Banking Committee. Washington, DC, 22 October 1999.

Walsh, John (*) Executive Director, Group of Thirty. Washington, DC, 19 February 1999.

Walker, Sir David (*) Chairman, Morgan Stanley Dean Witter – Europe. London, 6 January 2000.

Confidential interviews:

Federal Reserve Board, Division of Banking Supervision and Regulation. Washington, DC, 18 February 1999.

US Treasury Department, Federal Financial Policy Analysis. Washington, DC, 18 February 1999.

(*) Denotes G-30 members and Executive Director