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Restraining regulatory capture? Anglo-America, crisis politics and trajectories of change in global financial governance

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The headline story to emerge from the financial crisis of 2007–2009 in global economic governance terms was the displacement of the G7/G8 by the G20 as the principal policy forum or 'steering committee' at the apex of global governance.[1] But global economic governance consists of more than just state-based multilateralism. It encompasses important questions about the nature of the appropriate relationships between public and private actors and the world-view associated with those relationships. Such questions go to the very heart of the contemporary global financial order. Indeed, the question of how financial market actors are to be regulated by public authorities has been a particular focus for the G20 in its post-crisis discussions. Moreover, a growing number of respected commentators now argue that regulatory capture of public agencies and public policy by leading banks was one of the main causal factors behind the financial crisis of 2007–2009.[2] This, it is claimed, resulted in a permissive regulatory environment that placed faith in banks' own internal risk models, contributed to pro-cyclical behaviour and turned a blind eye to excessive risk-taking. This article argues that a form of 'multilevel regulatory capture' characterized the global financial architecture prior to the crisis, simultaneously feeding off and nourishing the financial boom in a fashion that mirrored the life-cycle of the boom itself. Minimizing future financial booms and crises will require continuous, conscious, explicit efforts to restrain financial regulatory capture, now and into the future. The article assesses the extent to which this has been achieved in current reform efforts and highlights some of the persistent difficulties that will continue to hamper efforts to restrain regulatory capture.

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1 See Andrew Cooper's article in this issue.

2 Simon Johnson, 'The quiet coup', *The Atlantic*, http://www.theatlantic.com/doc/print/200905/imf-advice, accessed 9 Dec. 2009; Simon Johnson and James Kwak, *13 bankers: the Wall Street take over and the next financial meltdown* (New York: Pantheon, 2010); Willem Buiter, 'Lessons from the global financial crisis for regulators and supervisors', paper presented at 'The global financial crisis: lessons and outlook', 25th anniversary workshop of the Advanced Studies Program of the Institut für Weltwirtschaft, Kiel, 8–9 May 2009; Avinash Persaud, 'Boomtime politicians will not rein in the bankers', *Financial Times*, 26 Nov. 2009.

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Financial regulatory capture was most pronounced in the Anglo-American heartland of the global financial system, in the heavily 'financialized' societies of the United States and the United Kingdom where the crisis originated. Indeed, financial regulatory capture was a key defining feature of the political economy of these countries, often alluded to in the evocative phrase 'Wall Street–Treasury complex'.[3] Evaluating the extent of regulatory capture before and after the crisis is therefore an essential part of coming to a rounded understanding of the politics of the crisis of 2007–2009 and assessing patterns of change in domestic and global governance arrangements. This article argues that several changes under way in the field of global financial governance seem to weaken the degree of regulatory capture at present, but deeper long-term structural problems may limit the extent to which it can be effectively restrained into the future.

The article is divided into three principal sections. The first section makes the case that regulatory capture occurred on several levels and followed a life-cycle that moved in parallel with the financial boom. Four mechanisms of regulatory capture are then specified: lobbying; degree of political salience; institutional design / revolving doors; and intellectual capture. The next section examines what is happening to these mechanisms as a consequence of a variety of post-crisis changes in domestic and global financial governance. The evidence concerning the extent to which regulatory capture is being effectively restrained is somewhat mixed, but to the extent that it is happening, it is largely unintentional and accidental. Recent reforms have overlooked the political causes of the crisis and have failed to focus explicitly or systematically on regulatory capture. Given the pro-cyclical nature of regulatory capture, this is a major oversight. The third section of the article provides some concluding reflections.

Multilevel regulatory capture and the Anglo-American financial crisis

Boom-time politics and the life-cycle of Anglo-American regulatory capture

Regulatory capture occurs when bureaucrats, regulators and politicians cease to serve some notion of a wider collective public interest and begin to systematically favour specific vested interests, usually the very interests they were supposed to regulate and restrain for the wider public interest. Financial regulatory capture in both the US and the UK was not a static phenomenon but evolved through a life-cycle that moved in parallel with the long financial boom of the late 1990s and 2000s.[4] This is an argument that has been made by others elsewhere, but a brief summary is provided below.[5]

[3] Jagdish Bhagwati, 'The capital myth: the difference between trade in widgets and trade in dollars', *Foreign Affairs* 77: 3, 1998, pp. 7–12; Robert Wade and Frank Veneroso, 'The Asian crisis: the high debt model versus the Wall Street–Treasury complex', *New Left Review*, no. 228, March/April 1998, pp. 3–23.

[4] For the original statement that regulatory capture moves through a life-cycle, see Marver Bernstein, *Regulating business by independent commission* (Princeton, NJ: Princeton University Press, 1955).

[5] Johnson and Kwak, *13 bankers*; The Warwick Commission on International Financial Reform, *In praise of unlevel playing fields* (Coventry: University of Warwick, Dec. 2009).

International Affairs 86: 3, 2010

The basic history of this 'life-cycle' evolved over 20 years of regulatory easing that facilitated financial innovation and the emergence of a largely unregulated shadow banking sector, including new risk management techniques based on an 'originate to distribute model'. The 'originate to distribute' model saw loans and credit repayment schedules sliced up, repackaged and sold on, in a variety of financial instruments, in an effort to spread and diffuse risk. These instruments included mortgage-backed securities (MBS), credit default swaps (CDS) and collateralized debt obligations (CDOs). As the sector and profits grew, the use of banks' own internal risk management models became widely accepted. This was justified on the basis of efficient market theories that markets are always self-equilibrating, that financial innovation is always beneficial, and that market discipline and incentives will lead bank management to make optimal decisions.[6] As asset prices continued to rise and the profits of banks soared, so regulators accepted the arguments of big banks that they should have lower capital requirements because they had sophisticated risk models.[7] Many banks, including Northern Rock, convinced regulators that they could hold just 2 per cent of capital against large and risky asset portfolios. Unfortunately, banks' internal risk assessments worked via daily price-sensitive risk limits, requiring a bank to reduce exposure when the probability of losses increased as a result of falling asset prices. As large banks' risk assessment systems bore close resemblance to one another, banks tended to hit their risk limits simultaneously and therefore had to sell the same assets at the same time, resulting in plummeting asset prices and financial herding.[8]

Boom-time politics also created serious disincentives for politicians to take corrective action, or question the banks' claims, because a continuation of the boom increased the likelihood of re-election.[9] Bankers were able to justify astronomical salaries and bonuses based on the profits generated by their supposedly innovative, sophisticated investment strategies. In such a climate of euphoria, and with so many powerful voices making the same arguments, underpaid and under-resourced regulators felt unable to speak up and proclaim the boom unsustainable. In this respect, regulatory capture in the financial sphere was an inherently pro-cyclical phenomenon, with significant intellectual and psychological elements. Financial regulatory capture and the financial boom of the 2000s coexisted in a mutually dependent life-cycle.

At some point in the early 2000s regulatory capture became so extreme that it breached a crucial threshold and became dangerously pathological, facilitating the excessive risk-taking that led to the bailouts of 2008.[10] Ultimately, the very

6 The most high-profile champion of this view was former Federal Reserve chairman Alan Greenspan.

7 The Warwick Commission on International Financial Reform, chaired by Avinash Persaud, makes the argument that this focus on internal risk management computer models placed an emphasis on IT capacity rather than risk capacity, resulting in an approach that was process-oriented rather than results-oriented.

8 Avinash Persaud, 'Sending the herd off the cliff edge: the disturbing interaction between herding and market-sensitive risk management systems', *World Economic Strategy* 1: 4, 2000, pp. 15–26.

9 Persaud 'Boomtime politicians will not rein in the bankers'.

10 Important as such an observation is in explaining what caused the financial crisis of 2007–2009, it still struggles to explain the precise timing and scope of the financial crisis, because of the sheer complexity of the conjuncture of circumstances leading up to the crisis. I am grateful to Chatib Basri for this observation. Global

regulatory climate that the banks themselves had created, through the deployment of vast intellectual, financial and lobbying resources, proved harmful to them at vast expense to taxpayers.[11]

While this brief account gives a flavour of how regulatory capture proceeded and contributed to the financial crisis, the mechanisms at work in this process need to be further dissected and specified.

Multilevel regulatory capture

Financial regulatory capture has simultaneously been multilevel and multifaceted. Capture was particularly pronounced in national settings in the US and UK, but it was not an exclusively national phenomenon. It also spilled over into technocratic transnational networks such as the Basel Committee on Banking Supervision (BCBS) and into more political intergovernmental processes such as the G7. In other words, multilevel regulatory capture reflected the mutual dependence and reciprocity between domestic and international spheres that has long been recognized by scholars in International Relations and International Political Economy. As such, multilevel regulatory capture was an example of a specific international state–society complex.[12]

Nationally, regulatory capture came together in what Simon Johnson has referred to as a confluence of campaign finance, ideology / 'cultural capital' and personnel connections.[13] Consequently, the US Congress and agencies such as the Treasury Department, the Federal Reserve, the Securities and Exchange Commission (SEC), and in Britain HM Treasury, the Bank of England and the Financial Services Authority (FSA), presided over a series of deregulatory reforms excessively favourable to the biggest banks. These agencies also participated in international settings such as the BCBS, the G7 and the Financial Stability Forum (FSF).

Regulatory capture was extended beyond national agencies in the US and the UK into the international arena by direct and indirect effects. A direct effect involved lobbying of the BCBS by the Institute of International Finance (IIF), an umbrella industry body dominated by the world's leading banks. The IIF not only wrote the first version of what became the Basel II agreement, which established a reliance on internal risk management systems based on state-of-the-art value-at-risk models for the biggest banks, but also engaged in continuous consultations with the BCBS, effectively allowing the IIF, as the regulated body, to 'write the entire Basel II policy script'.[14] The indirect effect at work in these settings

imbalances have also been cited as a cause of the crisis (see Paolo Guerrieri's article in this issue), as have excessively loose monetary policy and lending policies in the US mortgage sector.

11 These measures also increased industry concentration, increasing worries about institutions that are 'too big to fail' and moral hazard issues.

12 Robert Cox, 'Social forces, states and world orders: beyond international relations theory', *Millennium: A Journal of International Studies* 10: 2, 1981, pp. 126–55.

13 Johnson, 'The quiet coup'.

14 Eleni Tsingou, 'Transnational private governance and the Basel Process: banking regulation and supervision, private interests and Basel II', in Jean Christophe Graz and Andreas Nolke, eds, *Transnational private governance and its limits* (London: Routledge, 2008), pp. 58–68.

stemmed from a tendency for other states to defer to US and UK representatives on regulatory questions, because they were home country regulators for institutions in the City of London and Wall Street and therefore had most exposure to the latest practices and technologies of the biggest banks and the best grasp of the issues at stake. Indirectly, leading banks in the US and the UK were therefore able to shape international regulatory debates in the BCBS through disproportionate international influence exercised by US and UK officials.[15]

Multilevel regulatory capture of the sort described above was constituted and created by four causal mechanisms, which overlapped with and complemented one another: the concentration of material resources and direct lobbying; the political salience and inherent pro-cyclicality of financial regulation; revolving institutional doors; and intellectual and cognitive capture.

The concentration of material resources and direct lobbying

The operation of lobbying concentrations based on powerful producer or industry lobbies is well documented in the regulatory capture literature, going back to George Stigler's economic theory of regulation.[16] The basic argument advanced by Stigler was that concentrated industry lobbies had incentive, information and organizational cost advantages that allowed them to overcome collective action problems and engage in lobbying for regulation designed for the industry's benefit. For Stigler's Chicago School followers, this resulted in inefficiencies such as distorted competition and pricing.[17] Stigler's ideas can certainly be supported by the evidence from the United States in the buildup to the current crisis. In this respect, as Johnson and Kwak have recently pointed out, during the 1990s and 2000s great concentrations of wealth in the financial sector gave bankers huge political weight, resulting in the emergence of an American financial oligarchy that provided enormous amounts of campaign financing.[18] Further empirical support for this argument came in a recent IMF paper which found a strong statistical correlation between lobbying and campaign contributions by financial institutions and the tendency of those institutions to engage in high-risk securitization practices, as measured across cases of lobbying in respect of 31 financial reform bills in Congress.[19] Moreover, the general trajectory of reform in this period was entirely congruent with the banking industry's wishes. Reforms included repeal of the Depression-era Glass–Steagall Act, which separated commercial and investment banking activities; a total congressional ban on the regulation of CDS; and

[15] Duncan Wood, *Governing global banking: the Basel Committee and the politics of financial regulation* (Aldershot: Ashgate, 2005).
[16] George Stigler, 'The economic theory of regulation', *Bell Journal of Economics* 2: 1, 1971, pp. 3–21.
[17] Sam Peltzman, 'George Stigler's contribution to the economic analysis of regulation', *Journal of Political Economy* 101: 5, 1993, pp. 818–32. The evidence from this crisis would suggest that the answer does not lie in deregulation in the banking sector, largely because of the negative externalities generated by the crisis for all sectors of the economy, including taxpayers, and the social utility of all regulation should not consequently be questioned simply on efficiency grounds as the Chicago School has asserted.
[18] Johnson and Kwak, *13 bankers*.
[19] Deniz Igan, Pragan Mishra and Thierry Tressel, 'A fistful of dollars: lobbying and the financial crisis', working paper 09/287 (Washington DC: IMF, Dec. 2009).

an agreement between the largest investment banks and SEC officials in April 2004 that banks could take on larger amounts of debt.[20] Finally, as the earlier discussion revealed, a pattern of concentrated industry lobbying was also strongly evident in the unprecedented IIF influence on and access to the negotiations of the Basel II Accord.

The political salience and inherent pro-cyclicality of financial regulation

Generally, during financial booms the wider public has little interest in financial regulation—the distributional consequences remain highly technical, and therefore unclear to the general public—and so the issue has little political salience.[21] Of course, the one group to whom the distributional consequences are most clear and who have the greatest incentives to seek to influence regulation are the banks and their concentrated industry lobbies. In this context, during booms bank interests find themselves relatively unopposed because countervailing societal interests are largely absent. Compliant and uninterested domestic publics also enable bank lobbies to drive through international agreements such as Basel II with an almost complete lack of public scrutiny. Capture is therefore relatively easy during boom periods, but becomes much harder when regulation is repoliticized in the context of a crisis.

Revolving doors and institutional design

The literature on regulatory capture has also flagged up the issue of 'revolving doors' that facilitate the flow of people between public and private sectors in both directions, leading to 'colonization' of regulatory agencies and dysfunctional incentive structures for regulators. Some of the literature on regulatory capture has highlighted how regulators are encouraged to become compliant with industry wishes through implicit promises of lucrative future careers in the regulated industry.[22] The usual route in the US, however, appeared to involve a move from the industry into a public policy role, followed by a return to the industry. A 'Wall Street–Washington corridor' appears to have been in operation in the United States for over ten years, with many Goldman Sachs alumni in particular taking up key public policy posts at the Treasury and the Federal Reserve.[23] Borrowing from the French sociologist Pierre Bourdieu, Johnson refers to the array of personal connections and the relatively narrow social universe these revolving-door connections facilitated as a form of 'cultural capital' or belief system, based on a view that what was good for Wall Street was also by definition

[20] Daniel Kaufman, 'Corruption and the global financial crisis', www.forbes.com/2009/01/27/corruption-financial-crisis-business-corruption09, accessed 26 Jan. 2010.

[21] Ben Thirkell-White, 'Dealing with the banks: populism and the public interest in the global financial crisis', *International Affairs* 85: 4, 2009, pp. 689–711.

[22] Toni Makkai and John Braithwaite, 'In and out of the revolving door: making sense of regulatory capture', *Journal of Public Policy* 12: 1, 1992, pp. 61–78.

[23] Robert Rubin, Henry Paulson and William C. Dudley are among the better-known individuals making that journey, while Gerald Corrigan left the New York Federal Reserve and became CEO of Goldmans.

good for the US.[24] Such patterns of public–private crossover were also evident in the UK, where the head of group regulatory risk at HBOS, Paul Moore, reported serious concerns about the number and level of risks taken by his bank, only for the FSA to remain silent on the matter. Moore was later dismissed by HBOS. During 2004–2006, at the height of the boom, James Crosby, CEO of HBOS, was also on the board of the FSA: thus the head of a regulated institution was overseeing the regulator. The episode raised the question of why regulators failed to make full use of the information at their disposal.[25]

Revolving doors and linked 'professional ecologies' have also been evident in various international committees as public officials have sought to make use of private sector expertise. Consequently, the distinction between public and private sectors has often been blurred, creating genuine like-minded financial transnational policy communities.[26] Moreover, the small, club-like, transgovernmental design of many international financial fora, such as the G7, the FSF and BCBS, has made it relatively easy for the US and the UK to dominate in these settings, indirectly allowing the interests of leading banks in the major financial centres to dominate international agendas.[27] This tendency was compounded by the confusing mandates given to some regulators, such as the FSA, where regulation in the public interest was combined with a role as international champion of the City of London.

Intellectual and cognitive capture

Surveillance and monitoring of bank activities by regulators, creates a need for information-gathering from market participants. The personal connections, networks and repeated interactions that result can lead to the personnel of leading banks heavily influencing the thinking and mindsets of regulators. Extensive accounts of these interactions and the kinds of socialization pressures associated with them now exist.[28] Perhaps the most influential factor in terms of cognitive capture, however, was evident in the promotion of and deference to efficient market theories by powerful and charismatic figures such as Alan Greenspan, which elevated these theories to the status of an orthodoxy. Pro-cyclicality was again to the fore here as prominent academic economic theories largely justified the status quo during a period of financial success, as the efficient market hypothesis provided the intellectual foundations for the Basel II Accord and regulatory orientation more generally.

[24] Johnson, 'A very quiet coup'.

[25] Andrea Prat, 'A political economy view of financial regulation', *Vox Commentary*, 9 March 2009, http://www.voxeu.org/index.php?q=node/3213, accessed 26 Jan. 2010.

[26] Leonard Seabrooke and Eleni Tsingou, 'Revolving doors and linked ecologies in the world economy: policy locations and the practice of international financial reform', Centre for the Study of Globalisation and Regionalisation working paper 260/2009, University of Warwick http://www2.warwick.ac.uk/fac/soc/csgr/research/workingpapers/2009/26009.pdf, accessed 25 Sept. 2009.

[27] Andrew Baker, 'Deliberative equality and the transgovernmental politics of the global financial architecture', *Global Governance* 15: 2, 2009, pp. 195–218.

[28] Jo Becker and Gretchen Morgenson, 'Geithner, member and overseer of finance club', *New York Times*, 27 April 2009.

With entry into the financial policy-making community often dependent on postgraduate economics qualifications from the leading Anglo-American graduate schools, arguments from banks about their capacity to manage their own risk took hold in regulatory policy communities with relative ease, as such arguments largely resonated with the formal training of regulators and policy-makers. In this respect the informal, club-like attributes of many of the leading international financial fora also facilitated a highly consensual form of 'groupthink'.[29] Moreover, the apparent intellectual hold of efficient market theories went well beyond technical regulatory settings such as the BCBS to include the G7's round of meetings between finance ministers and central bank governors, which repeatedly promoted the world-view associated with the efficient market hypothesis, consistently advocating transparency, market discipline, the advantages of capital account liberalization and financial innovation in communiqués and statements for well over a decade.[30]

Restraining regulatory capture? Trajectories of change in global financial governance

Following the financial crisis, as Eric Helleiner's contribution to this special issue has pointed out, the neo-liberal financial order of the last 30 years entered a 'legitimacy crisis'. Crucially, as the discussion above has sought to illustrate through a dissection of the multilevel and multifaceted nature of regulatory capture, that financial order was politically and socially constructed. In this respect, multilevel regulatory capture was a key political and institutional constellation that facilitated the growing political and economic power of Wall Street and the City of London. However, it was also the Achilles' heel of the neo-liberal financial order, undermining its legitimacy and directly contributing to the destructive and ultimately self-defeating behaviours that produced the crisis. If the recent crisis *is* genuinely a catalyst for change in global economic governance, a crucial question that has to be examined is whether financial regulatory capture is being challenged and restrained, both domestically and internationally. If this were to happen, global financial governance would begin to function quite differently. Each of the aspects of regulatory capture identified earlier will now be examined in turn, in the light of post-crisis policy and institutional change.

Has the concentration of material resources and direct lobbying been reduced?

Over the last 30 years the largest investment houses and their industry associations have become adept at exerting political influence. In the process they have accumulated vast financial resources, experience of regulatory debates and

[29] Warwick Commission on International Financial Reform, *In praise of unlevel playing fields*, p. 28.
[30] Andrew Baker, *The Group of Seven: finance ministries, central banks and global financial governance* (London: Routledge, 2006).

of legislative and policy-making processes, and personal connections. As the previous section illustrated, the literature on regulatory capture acknowledges these problems. Sophisticated institutions that stand to gain billions, with access to the best lawyers and accountants, are always likely to have a disproportionate influence on regulatory practice. However, an added dimension to this persistent danger of regulatory capture has emerged in the 'too big to fail' issue and the emergence of supersized investment banks like Goldman Sachs.[31] Under these conditions banks have an implicit guarantee that their risk-taking will be covered by taxpayers' money and future bailouts. Moreover, internationally among the G20 deputies (finance ministry officials) there is now an implicit understanding that the lesson learned from the collapse of Lehman Brothers is that the costs of bailing out a bank are much lower than those incurred when a bank collapses.[32] In many respects, therefore, post-crisis developments seem to indicate that the privileged position of banks has actually been entrenched rather than diminished, because future losses now appear to be guaranteed by governments (although, as we shall see, some other trajectories of change point to banking sector lobbies adopting a more defensive position).

Moreover, one expert called to testify before the Senate Banking Committee hearing on the 'Volcker Rule' to limit the proprietory trading activities of banks is already indicating that the power of the banking lobby is alive and well. His claim is that bank lobbies' relationships with key Republican senators will ensure that no meaningful versions of the Volcker rules make it into law, while Wall Street firms are already targeting money to defeat political candidates who have opposed them in the current round of congressional hearings.[33] Such accounts demonstrate the entrenched structural asymmetries that continue to dominate financial regulatory politics in the US. Notably, the crisis has not produced any effort to address, at least in any systematic fashion, the questions of campaign finance and lobbying activities. In other words, the political causes of the crisis appear to have been something of a blind spot in the current crisis response.

Furthermore, regulatory capture was in part a natural outcome of the 'financialization' of Anglo-American society and the sheer size of the financial sector. It therefore becomes difficult to conceive of how financial regulatory capture, similar to the sort we have witnessed during the 1990s and 2000s, could be prevented without a radical overhaul and reduction of 'financialization' in both US and UK society. In this respect, Anglo-American elites face serious disincentives in retreating from financialization, securitization and the access to credit and housing finance that has flowed from those technologies, because these processes have become integral elements of the social and welfare settlements in these societies, and politicians and publics alike will be reluctant to roll them back.[34] The

[31] The generous terms of the Toxic Asset Relief Programme can be cited as further evidence of regulatory capture.

[32] Confidential remarks made by official to the author under Chatham House rules.

[33] Simon Johnson, 'Goldman Sachs and the Republicans', *The Baseline Scenario*, http://baselinescenario.com/2010/02/05/goldman-sachs-and-the-republicans-2/, accessed 20 Feb. 2010.

[34] Leonard Seabrooke, 'Responsible credit and welfare', commentary in Warwick Commission on International Financial Reform, *In praise of unlevel playing fields*, pp. 29–30.

financial sector and the banks can also continue to use competitiveness arguments and regulatory arbitrage in an effort to minimize future regulation, through the threat of capital flight.

Yet the overall picture is more complicated than the examples above may suggest. In other respects, the banking industry is on the back foot and is now prepared to accept regulation and measures that it would not have countenanced even 18 months ago. In this sense, dominance of the terrain of the regulatory debate has clearly shifted away from the largest banks towards newly invigorated regulators and policy-makers. Numerous examples can be cited, including Barrack Obama's plan to impose a 'Volcker Rule'. Gordon Brown has sought to instigate a serious international debate on the imposition of a transactions levy or 'Tobin tax', on which the IMF is compiling a report published in April 2010. Some support for such a proposal even exists in the City of London: for example, Ethical Currency, a City foreign exchange broker, voluntarily adopted a Tobin tax in September 2009 and INTL Global Currency successfully trialled a transaction levy software system.[35] At the FSA, Adair Turner has initiated a debate over the need to 'right-size' the financial sector to a more appropriate share of national GDP, a need also expressed in the US by Obama. There is now both domestic and international agreement, by public and private actors in the UK, the US, Europe and across the G20, on the need for the use of central clearing counterparties (CCPs) in over-the-counter derivatives trading.[36] Internationally, the BCBS and the new Financial Stability Board (FSB) are working on macroprudential regulation, which would require banks to build up countercyclical capital buffers and hold much more capital. Concerted opposition from groups such as the IIF on these issues has been muted. At the very least, taken in their totality, these developments suggest that the lobbying capacity and voice of bank lobbies are not what they were prior to the crisis. Their oppositional attitudes to regulation are softening, while regulators are emboldened. Certainly, the IIF is no longer writing the international policy script in its entirety, even if it does remain highly influential.

The increasing political salience of financial regulation

The reasons for the developments described above and the apparent softening of the positions of bank lobbies, together with a weakening of their political position, lie in a genuine sense of public anger and resentment at the behaviour of the financial sector. Not only has the political salience of financial regulation increased markedly, but the distributional consequences of financial regulation have become much clearer with costs imposed on taxpayers by bank bailouts and looming public expenditure cuts. Popular demands for tighter regulation and

[35] Nick Mathiason and Jill Treanor, 'Gordon Brown in secret push to sell Tobin tax to City', *Guardian*, 9 Nov. 2009.

[36] Eric Helleiner and Stefano Pagliari, 'The end of self regulation? Hedge funds and derivatives in global financial governance', in Eric Helleiner, Stefano Pagliari and Hubert Zimmerman, eds, *Global finance in crisis: the politics of international regulatory reform* (London: Routledge, 2010).

more constraints on the activities of banks have consequently surged. Likewise, reduced access to credit for business, consumers and homeowners has produced an economic downturn that, though induced by the financial sector, is bearing most heavily on ordinary householders, consumers, taxpayers and workers, demonstrating the negative externalities generated by a financial crisis. At the same time, bank executives have continued to avail themselves of huge rewards, thus prolonging public anger at City and Wall Street institutions. Activist politicians across the G20—not just Obama and Brown, but also Angela Merkel, Peer Steinbruck and Nicolas Sarkozy—have been seeking to inject political energy and urgency into the regulatory reform agenda, while increasing their domestic political capital by pushing extensive domestic reform programmes. Meanwhile, through the platform of the G20, they have also set political priorities for international technical committees such as the BCBS and the FSB, with macroprudential regulation repeatedly highlighted as a priority in G20 communiqués.

In such a political climate, public attention has been drawn to the behaviour of banks. Consequently, the banks no longer have everything their own way on regulatory questions. Indeed, on many issues, as the discussion above has illustrated, they are on the back foot and fighting a rearguard action. The problem here is that public anger and political interest in regulation are also temporary and inherently pro-cyclical. Regulators and policy-makers consequently face the difficult task of formulating, agreeing and finalizing new, appropriate and politically feasible regulatory practice quickly enough to make the most of a limited public attention span.

Addressing revolving doors and institutional design

What has been lacking in the regulatory response to the crisis so far is acknowledgement of the role of regulatory capture in the crisis, and any attempt to address it explicitly and systematically. For example, the issue of revolving doors between regulator and regulated has received little attention in existing reform debates, either internationally or domestically. But limits on this kind of activity would be quite easy to implement by enforcing legally defined time periods during which a former regulator could not move into the regulated industry, or someone from a regulated industry into a regulatory position. Precise details could be debated, but the issue is conspicuous by its absence from either domestic or international agendas. Similarly, questions of how to motivate, fund and train financial regulators could all be looked at, evaluated and addressed in a systematic fashion, in an effort to restrain the extent of regulatory capture. Again little attention has been focused on this area. In short, the phenomenon of multilevel capture has been addressed only in an indirect and somewhat incidental fashion in the regulatory response to the crisis, in both domestic and international policy-making circles. Given the pro-cyclical nature of regulatory capture, this rather incidental approach is unlikely to be successful in restraining regulatory capture in the long term.

In the international arena more attention has been paid to institutional design issues, but again the dangers of regulatory capture have not been focused on explicitly: rather, a range of developments have had somewhat unintentional, piecemeal and accidental effects where regulatory capture is concerned. For example, the move to replace the G7 with the G20 as the leading financial policy forum may have unintended long-term consequences relating to the capacity of the US and the UK to dominate international financial deliberations. It may become more difficult for the largest global investment banks to have their preferences and positions represented by proxy at the apex of international policy-making. This trend, though it may be perceptible only in the long term, is likely to be accentuated by the growing financial power of Brazil and China, which, despite having large banks, remain wedded to a 'real economy' model and identify a need for tighter regulation of finance. The views of China and Brazil may take time to percolate upwards on regulatory questions because financial governance is an inherently incremental, path-dependent and technical exercise that draws heavily on previously accumulated technical knowledge and reports.[37] However, the trajectory of reduced Anglo-American dominance seems a probable long-term outcome. Furthermore, for the first time, the BCBS and the technical committee of the International Organization of Securities Commission (IOSCO) have had their membership expanded to include a range of key emerging markets, while FSB membership is now extended to all G20 countries. To date emerging markets have been relatively muted and have made few contributions on regulatory issues, even during the current crisis,[38] in which the debate has continued to be dominated by Europeans and Americans; but oppositional attitudes to the Anglo-American perspective of the past 30 years are far more numerous and more vociferously expressed than was previously the case.

A further international institutional design issue that the crisis has exposed is the asymmetry of multilateral surveillance, which was formerly focused mainly on emerging markets and developing countries. This bias is now viewed as unsustainable, both financially and politically. For example, the US, which had previously opted out of Reports on the Observance of Standards Codes (ROSCs) conducted by the IMF and the World Bank, has now entered into an entire Financial Sector Assessment Programme (FSAP) to be overseen by the IMF. It would be a mistake to attach too much importance to this, as some have suggested the standards and codes exercise simply gives rise to a situation of mock compliance.[39] However, an alternative perspective, which views the surveillance exercise as a tool for policy dialogue relating to future reform rather than enforcement,[40] suggests that US

[37] Tony Porter, 'Technical collaboration and political conflict in the emerging regime for international financial regulation', *Review of International Political Economy* 10: 3, 2003, pp. 520–51.

[38] Interviews conducted by Brendan Carey, PhD student in the School of Politics, International Studies and Philosophy, Queen's University of Belfast, with a range of emerging market finance ministry and central bank officials during 2009.

[39] Andrew Walter, *Governing finance: East Asia's adoption of international standards* (Ithaca, NY: Cornell University Press, 2008).

[40] Swati Chaudhury and Leonard Seabrooke, 'Pragmatic numbers: how the IMF creates policy dialogue for financial reform', CSGR working paper 261/09, University of Warwick, 2009 http://www2.warwick.ac.uk/fac/soc/csgr/research/workingpapers/2009/26109.pdf, accessed 10 Oct. 2009.

domestic debates on financial stability may become less insular and more open to external viewpoints. The direct capture of US regulatory agencies may become more difficult in such circumstances.

Another development is the formation of a stronger FSB as a supposed fourth pillar of global economic governance. The FSB's predecessor, the FSF, appears to have been prevented by the US from doing anything other than reporting on the work of other international regulatory bodies such as the BCBS, the International Accounting Standards Board (IASB) and IOSCO.[41] In effect, the US and by proxy its financial sector exercised a significant power of veto over a key institution of global financial governance. The new FSB has been charged with focusing more fully on those jurisdictions that pose a threat to systemic stability because of their weak adherence to relevant standards.[42] A potential implication of this is that the FSB spotlight, given the origins of the crisis, will shine on major financial centres such as the US and the UK. This will be a conspicuous change of emphasis should it materialize. Furthermore, some of the areas the FSB is set to assess include the extent to which adequate measures to mitigate pro-cyclicality have been undertaken, compensation practices have been reformed to support financial stability, capital provisioning and capital buffer arrangements are adequate and CCPs have been introduced. In this respect, the new focus of the FSB may partially inhibit direct capture of the US state by financial and banking lobbies, because increasing international pressure is being felt in all these issue areas to bolster the authority of regulators over the regulated.

Despite these developments, which suggest a changing balance of interstate power is partially recasting global financial governance, some of the forces of inertia in this sphere have not been fully addressed following the crisis. In particular, the revolving door syndrome in the international sphere, as in the domestic sphere, has largely been overlooked. Given the IFI's influence over the BCBS and allegations that such committees display a form of pro-market 'groupthink', such an oversight is potentially problematic. While country representation in the international regulatory apparatus has been expanded, the individuals involved are still predominantly technocrats from a relatively narrow intellectual background, representing a narrow range of domestic agencies that are primarily concerned with technical fixes for the current system. The opportunity to inject greater social and intellectual heterogeneity into debates in regulatory policy communities, including representation of a broader range of constituencies, has not yet been grasped.[43] Without a systematic consideration of how to broaden the number of intellectual and social perspectives represented at key domestic and international tables, regulatory capture may yet prove difficult to restrain.

41 Howard Davies and David Green, *Global financial regulation: the essential guide* (Cambridge: Polity Press, 2008).

42 Financial Stability Board, 'Progress since the Pittsburgh summit in implementing the G20 recommendations for strengthening financial stability', report of the Financial Stability Board to G20 finance ministers and governors, 7 Nov. 2009.

43 The justification for this would be the widespread negative externalities generated by financial crises.

Restraining intellectual and cognitive capture

It is in the area of intellectual mechanisms of regulatory capture that most progress has been made. One of the first casualties of the financial crisis was the premise that markets were self-regulating and that leading market players could manage their own risk through sophisticated modelling and microprudential risk management strategies. During 2008, once the full damage wrought by the crisis became apparent, new regulatory norms began to be developed in settings such as the BCBS, the Bank of International Settlements (BIS) and the FSB. As Eric Helleiner's contribution to this special issue indicates, the contours of a new but incomplete 'Basel consensus' have begun to take shape. A new lexicon has taken hold of regulatory debates. To the fore here is the idea of 'macroprudential regulation'. Support for this idea had existed within the research department of the BIS for some of the previous decade, and some elements of macroprudential regulation operated prior to the crisis in Spain, Colombia and India; but it enjoyed very little support in international technocratic networks such as the BCBS and was rejected in the US and the UK, regulators to the world's biggest banks. After all, for as long as the boom continued, claims about the adequacy of firms' micro risk management strategies as an ingenious solution to risk management appeared to hold. Yet such is the conversion to the cause of macroprudential regulation that one of its few advocates prior to the crisis has recently felt moved to pronounce that 'we are all macroprudentialists now'.[44]

One of the defining features of the previous regulatory approach enshrined in Basel II was that it placed the emphasis almost entirely on microprudential regulation, or financial firms' own risk management systems and models. Macroprudential regulation rejects such an approach. It claims that even if financial institutions and banks individually behave in a microprudential fashion, following risk management strategies and investment decisions that make perfect sense for them as individual institutions, and even if all banks do this, it will not necessarily guarantee the stability of the system as whole. That is to say, risk is endogenous (as well as dynamic). Individual microprudential behaviour can produce systemic herding and financial bubbles of the sort that emerged in the period up to 2007.[45] In other words, the case for macroprudential regulation rejects the efficient market hypothesis, which has been the principal intellectual cornerstone of the Anglo-American financial order as it has unfolded over the past 30 years, and also the argument that regulation can be solely microprudential.

Probably the most widely cited macroprudential instrument is the requirement for banks and financial institutions to build up countercyclical capital buffers during good times, which would restrict excessive investment patterns or herding, creating healthier bank balance sheets and enabling capital reserves to be drawn down during bad times. Such capital buffers are intended to dampen economic cycles and inject some much needed countercyclicality into the financial system—a

[44] Claudio Borio, 'Implementing the macroprudential approach to supervision and regulation', Banque de France, *Financial Stability Review*, no. 13, Sept. 2009, pp. 31–41.

[45] Persaud, 'Sending the herd off the cliff edge'.

kind of sand-in-the-wheels type proposal. A system of capital buffers operated in Spain and ensured that Spanish banks remained strong during the crisis, despite a massive fall in real estate prices. The operation of such countercyclical capital buffers would require a set of rules with which banks would have to comply, and would therefore mark an end to self-regulation. Not only does macroprudential regulation intellectually challenge self-regulation: if implemented properly, it implies a return to regulators telling banks what to do, thus reducing the extent to which regulators are captured.

When in late 2008 and early 2009 the G20 made macroprudential regulation a political priority, a process of drafting a series of more detailed national proposals commenced. This process is still under way. So too is the intense international monitoring of these developments by the FSB and the BCBS. Under instruction from the G20 and the FSB, the BCBS has agreed to construct concrete proposals on conserving capital to build capital buffers at individual banks that can be used in times of stress, as part of a comprehensive package to address pro-cyclicality by the end of 2010.[46] The final phase of the process of introducing macroprudential regulation will involve the enactment and implementation of national legislation—and it is here that financial lobbies will seek to derail and water down regulatory provision. With much disagreement over the detail of macroprudential provisioning, we are currently only halfway through a protracted, contingent and contested process of establishing macroprudential regulation, in which the extent of regulatory capture will have a crucial determining influence on outcomes. It is for this reason that the restraint of regulatory capture will be vital. The proper functioning of macroprudential regulation depends on limiting regulatory capture, and on limiting the capacity of bank lobbies to hollow out its provisions. However, as this article has argued, the politics that produced the crisis have largely been overlooked in reform efforts. Regulatory capture has not been an explicit focus of responses to the crisis. To the extent that regulatory capture has been restrained, it has largely been as an incidental side-effect of other reform efforts.

Notably, macroprudential regulation is also something of a narrow technical fix, devoted to making the existing system less pro-cyclical. While it makes a case for more public and state intervention, it does not provide the basis for a wider-ranging reordering of political and social relations, or for new social pacts, and it does not propose an alternative growth model. Indeed, in certain interpretations macroprudential regulation takes a minimal form in which macroprudential oversight and analysis constitute all that is feasible or desirable. Already there are powerful pressures and arguments emerging from industry lobbies and certain agencies in the Anglo-American world, suggesting that macroprudential regulation should only take a rather minimal and modest form.[47]

[46] FSB, 'Progress since the Pittsburgh summit'.

[47] For a recognition of this, see Avinash Persaud, 'The counter revolution begins: the rise and premature fall of macro-prudential regulation', 16 July 2009, http://blogs.warwick.ac.uk/warwickcommission/entry/the_counter-revolution_begins/, accessed 10 Aug. 2010.

Table 1: Life-cycles of financial regulatory capture

Mechanism of capture	*Status quo during 2000s, before the crisis*	*Response to date through global financial architectural reform*
Material resources and lobbying	• Strong concentration in favour of leading banks • Financialization of US and UK societies • High prestige and wealth of Wall Street and City: heavy focus on achieving desired regulatory outcomes • IIF writes Basel II script	• Political ascendancy of banking lobby is weakened, but resources and access remain pronounced, both internationally and domestically • 'Moral hazard' and 'too big to fail' issues become more explicit • Failure to address lobbying or campaign finance issues
Political salience of financial regulation	• Little interest among general public • Distributional consequences unclear to public • Capture easy as few counter-vailing interests	• Populist pressures for more stringent regulation • Distributional consequences become clear due to negative society-wide externalities • Bank lobby on the defensive, possibly temporarily
Revolving institutional doors	• Revolving doors rotate quickly • Public–private distinctions blur • Colonization of regulatory agencies • Salary incentive problems for public regulators	• Regulators appear reinvigorated • Revolving doors issue not addressed • Regulator training and incentives overlooked. • International regulators respond to domestic political climate and have more political space relative to transnational lobbies • More opposition to US and UK
Intellectual	• Ascendancy of efficient market theories on both sides of the Atlantic and in economics profession • Industry arguments seem plausible in the context of boom • Exclusive club design at international level facilitates groupthink	• Biggest impact of crisis is intel-lectual • Macroprudential regulatory (MPR) philosophy leads to intellectual independence from industry • Efficient market theories rejected • Increased European assertiveness • Individuals critical of previous orthodoxy rise to prominence through MPR

Conclusion

This article has argued that a form of multilevel regulatory capture was both a principal political cause of the financial crisis of 2007–2009 and one of the central political issues and challenges raised by the financial crash. However, it has not been confronted directly or explicitly in current reform efforts, and has been touched upon in only a somewhat piecemeal, incidental and indirect fashion in the changes emerging in the field of global financial governance. In this regard, the evidence on the extent to which multilevel regulatory capture has effectively been addressed in ongoing reform efforts is mixed, as table 1 shows. Notwithstanding the 'too big to fail' issue associated with oversized banks, for the time being there is, on balance, marginally less regulatory capture than existed prior to the crisis. This is most pronounced in the form of a changed intellectual climate, some signs of reduced US and UK influence in international governance fora, and a more defensive posture on the part of banking lobbies. However, the pro-cyclicality of regulatory capture, and the failure to address it explicitly, may yet mean that the same processes re-emerge more strongly than ever, with the same dysfunctional outcomes, once the next boom emerges. The failure to take a more systematic and explicit, rather than incidental, approach to restraining regulatory capture is therefore a major policy oversight. Addressing this oversight will be a necessary political precondition for more fundamental managed change, rather than forced change, in the global financial order.[48]

[48] For a worst-case scenario, see Peter Boone and Simon Johnson, 'Risk taking, regulatory capture and bailouts: the doomsday cycle', http://www.voxeu.org/index.php?q=node/4659, accessed 15 March 2010.