

The Emerging Post-Crisis Financial Architecture: The Path-Dependency of Ideational Adverse Selection

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Research Highlights and Abstract

This article

- Contributes to the debate on policy change and economic ideas after the crisis, finding ideas and material interests to be closely aligned and introducing the notion of 'ideational adverse selection'.
- Establishes that pre-crisis financial governance failed to provide financial stability yet provided benefits to precisely those whose advocacy underpinned its emergence.
- Argues that despite the adoption of a 'macroprudential approach', the post-crisis reform of financial governance promulgated by the Basel Committee and IOSCO does not (yet) admit of a 'paradigm shift'.
- Concludes that if ideational change and a shift in policy approach is to take place, the nature of the policy community as 'input' must also change.

This article focuses on two cases of transnational financial governance that confirm that ideas and material interests are closely aligned in the construction of regulatory institutions at the international level: the Basel-II/III international capital adequacy standards and the IOSCO-based regulatory processes that underpin cross-border securities markets. The article first establishes that the pre-crisis system of financial regulation and supervision left public authorities dependent on private sector expertise and information provision such that policy idea-sets became increasingly aligned with private sector preferences. Secondly, this market-based system of financial governance provided benefits to precisely those whose advocacy underpinned its emergence while facilitating neither financial stability nor resolving the weaknesses of national-level governance in a context of cross-border integration. Lastly, it remains unclear if either pre-crisis alternatives or the lessons of the crisis itself have been applied properly to the reforms. The reform debate continues to pursue an essentially market-based approach to the problem of financial governance at the national, regional and global levels. Policy failure endogenous to a pre-crisis regulatory coalition has so far failed to disturb the tenacity of material interests and inertia of institutional path dependency.

Keywords: economic ideas; financial governance; policy failure; regulatory capture; Basel Committee; IOSCO

This article focuses on the post-crisis financial reform process at the global level and assesses the extent and nature of the changes that have taken place. This analysis is framed by the debate about the role of ideas in post-crisis policy change, the theme of this special section of the *British Journal of Politics and International Relations*. The pre-crisis global financial system was characterised by a system of 'market-based' financial governance resting on 'soft law' mechanisms (Brummer 2012) across national, regional, and global levels and that significantly enhanced the role

and power of private market agents in these emerging national and international policy processes. This response to the policy dilemmas of financial sector liberalisation was directly linked to corresponding ideas on market-led adjustment and governance that became ascendant in policy circles in the wake of the previous economic crisis of the 1970s (Hall 1993).

This policy approach was aimed at providing financial stability but led directly to crisis. Both public and private sector actors built up a perceived community of interest in the implementation of shared ideas that proved extremely costly. The literature on financial governance provides a range of accounts of this process (e.g. Moran 1991; Helleiner 1994a; Cohen 1996; Baker 2005). This article further refines this debate by advancing the concept of 'ideational adverse selection' as a dynamic that leads to sub-optimal or simply bad policy outcomes. This is defined as the selection of ideas to accomplish a specific purpose in relation to public policy, in this case the achievement of financial stability, but wherein these ideas better serve the perceived interests of parties to the agreement rather than those of the public or the ends they were meant to achieve. Ideational adverse selection would typically be associated with relatively closed policy communities characterised by exclusionary constituency inputs, such as occurs under conditions of policy capture. The literature also gives us reason to expect that this failure should call the policy consensus into question. To what extent has this so far occurred? Has a new ideational consensus emerged and do post-crisis reforms represent a shift that is likely to lead to a greater degree of financial stability this time around?

The article advances its argument based on three claims about pre- and post-crisis outcomes. Firstly, during the thirty-year process of financial market liberalisation and cross-border integration, regulators and supervisors became more dependent on market interests in determining the pattern of governance, aligning financial governance with the preferences of powerful market players and strengthening the power of private agents to shape and set rules, a general trend often encouraged by states themselves (Cerny 1994; Helleiner 1994a, 1994b and 1995; Underhill 1997; Sobel 1998). This ideational adverse selection did not take place in a vacuum. The pre-crisis financial architecture produced substantial material benefits for precisely those that had proposed the approach in the first place. The policy paradigm became embedded in a transnational policy community charged with developing and implementing global standards of financial supervision and regulation. This ideational path-dependency institutionalised the material interests of private constituencies helping themselves to 'club' goods (Cornes and Sandler 1996; Tsingou 2014) under official auspices.

Secondly, this occurred despite the long-standing availability of alternative idea-sets combined with much historical evidence that provided grounds for scepticism that the emerging system of governance would provide the financial stability at which it was aimed. It was well known that employing price signals and financial market 'disciplines' in the service of risk management and an elusive financial stability was fundamentally flawed (see Sections 1 and 2 below). Empirically, market-based 'governance light' was associated with serial episodes of crisis for many societies to a degree that should have challenged the very foundations of this approach to global financial governance itself. The long shadow of the 2007-08 financial crisis

further demonstrated that the market-based system of governance in its pre-crisis form was singularly unsuccessful at providing either financial stability or efficient financial governance. There were plenty of calls for fundamental change.

Thirdly, it is argued that the post-crisis reforms so far have failed to embody a new approach to financial governance. While many 'new' ideas have been debated in the relevant policy forums as well as more publicly, they have yet to be put to practical use. The idea-set with the greatest promise for change, the 'macroprudential approach' to financial supervision, remains in a tentative phase of development and the required institutional innovations to make it work are as yet only under discussion (Baker 2013a; Helleiner 2014). The reforms continue to implement the market-based approach, albeit with higher and (for financial institutions) more costly standards. This outcome is in important measure because the constituents of the policy community itself are little changed. Until the balance of preference 'inputs' into the policy process shifts substantively, it is likely that the dominant idea-set will remain challenged but not superseded in the ongoing reform process.

This article advances these propositions in three steps. First, the article establishes alternative idea-set availability: what we knew from history and the literature that underpinned the pre-crisis debate about financial architecture. A second section examines the ideational underpinnings and emergence of the pre-crisis system of market-based financial governance. Thirdly and most importantly, the article analyses two significant global-level cases of financial supervision and regulation: the Basel Committee on Banking Supervision (BC) and the International Organisation of Securities Commissions (IOSCO). Each case begins with the establishment of the pre-crisis 'status quo' and compares this to the (ongoing) post-crisis reform outputs, with consistent reference to the contest of ideas and interests that underpin this process. This analysis supports the claims enumerated above: that despite the availability of alternative policy approaches, ideas and interests aligned in an adverse selection process embedded in institutional path-dependency, and that this pattern of ideational adverse selection has yet to be destabilised by the longest and deepest crisis since the Great Depression of the 1930s.

1. Global Financial Integration and the Lessons of the Literature

Global financial integration became a defining feature of the late 20th and early 21st centuries. This was part of a general market-oriented trend in economic policy that followed the apparent exhaustion in the crises of the mid-1970s and early 1980s of the thirty years of post-war economic miracle. Neo-classical economic ideas proposing market-led adjustment superseded the prevailing Keynesian paradigm (Hall 1986; Helleiner 1994). The policy shift was in turn justified in terms of broad, aggregate economic benefits for both the developed and the developing world. This shift in policy approach was characterised as a 'paradigm shift' in a now classic treatment by Peter Hall (1993). Hall's hypothesis, linking policy failure and crisis to the eventual emergence of new policy norms shaping the process of reform, has been central to the literature on the role of ideas in governance ever since (see Blyth 2002, ch. 2). Yet there remains the question as to why these market-friendly

ideas were chosen over the available alternatives. This section consequently argues two points: i) that the process of adverse ideational selection was closely linked to the material interests of the main players in the transnational policy community that from the 1980s on emerged to govern global finance; and ii) that ideas challenging the capacity of market-led systems of governance to provide financial stability remained prevalent (though not dominant), and that dissent grew as the historical record of the new system revealed an apparent link between the occurrence of financial liberalisation and serial crises.

Perhaps most importantly, states emerged from the 1970s and 1980s downturn with vast mountains of debt. Post-war full employment had long masked the extent of welfare commitments made by governments to their societies, and the cost that was involved if the chips were ever called in. The end of the baby boom and the ageing of the workforce would predictably make matters worse. Economic crisis and rising unemployment in the mid-1970s onwards meant that for the first time states actually had to *pay* for latent welfare state commitments while growth engines sputtered. This had to be financed, and once Paul Volcker ruled out inflation as a solution an adventure with financial internationalisation seemed a good bet.

OPEC oil surpluses provided markets with a massive increase in capital just as recession had dampened private appetites for investment. The public sector could conveniently fill this gap (Cohen 1982, 471) as state treasuries and increasingly independent central banks discovered the delights of access to international capital markets. As the favoured intermediaries for state finance, the major international banks were hardly averse to such a strategy. Governments and their economies gained enhanced access to international capital while large financial institutions facing market saturation at home gained access to new public and private markets. Transnational material interest coalitions were formed to press their own and foreign governments to engage in cross-border financial liberalisation (Underhill 1993) and this proved an enduring alliance for the promotion of cross-sectoral and cross-border financial market integration.

In short, changing idea-sets both drove and pursued the incentive structure of a rapidly-changing economic situation in reflexive fashion. A new approach to regulation and governance was one way out of a series of common policy dilemmas. State elites were central to the choice to take this route, along with their private sector partners in the financial sector. This period of rapid financial integration came to be punctuated by frequent and severe episodes of financial crises (Bordo et al. 2001). For a while these crises appeared limited to the 'emerging markets', which led to the implementation of market-friendly financial architecture reforms at the global level and in these 'weakest links' so as to adapt them better to the dynamics of financial markets.

Lessons We Already Knew

Modern financial economics had become concerned with the modelling of prices, information, and financial stability in relation to risk probabilities. The Efficient Market Hypothesis (EMH) as supplemented by modern portfolio theory has

dominated the theory and practice of contemporary financial markets and their governance. The theory proposed that the achievement of openness, of transparent information provision, and sound risk management would yield stability, and so these principles became enshrined in the strategies of financial institutions, of market authorities, and of financial supervisors (see Taylor 2004, esp. 241–264).

Yet we have long known that the management of financial openness was less than straightforward. There was historical and contemporary evidence a-plenty (de Cecco 1975; Kindleberger 1989; O'Brien 1992; Galbraith 1993, 1995; Cohen 1998 esp. ch. 8; Rajan 2006). The case for adequate governance in the form of supervision and regulation was well-understood and entrenched in the fabric of post-Depression post-war economic systems. Had it not been for the powerful private-public constituency that perceived an interest in pursuing global financial integration, these cautionary messages in the economics, political economy, and financial regulation literatures might have served as ample warning that this path was potentially problematic (Helleiner 2011). At least four such ideational messages could be distilled from the pre-crisis literature (Underhill et al. 2010):

Lesson 1: Financial Instability Prevalent. A first message has already been alluded to: a high degree of capital mobility combined with market integration constitutes an inherently unstable system (Kindleberger and Laffargue 1982). Susan Strange had argued that the rise of off-shore and de-regulated financial markets outside national systems of governance had largely been responsible for the breakdown of the international monetary system during the 1970s (Strange 1976, ch. 6; 1986). A range of scholars followed Strange's lead (e.g. Moran 1991; Cerny 1993) to focus on this 'phoenix risen' (Cohen 1996) of global finance and the domestic dimensions of policy change (Moran 1984; Pauly 1988; Rosenbluth 1989; Coleman 1996).

There was a corresponding avalanche of literature in economics. The debate as to whether equilibrium could be achieved automatically under conditions of financial liberalisation ran for many years (see, e.g. Minsky 1982; Bhagwati 1998; Rodrik 1998; Stiglitz 2000, 2002). Others debated the balance of economic costs and benefits of financial openness (King and Levine 1993; Demetriades and Hussain 1996) and/or possible systems of regulation and supervision (Steil 1994; Barth et al. 2006). Prominent financial sector practitioners such as George Soros (2005), Warren Buffet or Henry Kaufman, and especially Avinash Persaud (2000) warned of the dangers. Borio and White (2004) among others either inside or with close links to the Bank for International Settlements where the BC is based (Borio et al. 2001; White 2006; BIS 2006; see discussion Baker 2013b, 114–18) presented a series of arguments linking financial instability to the collective behaviour of financial institutions as they interacted with credit cycles, payments imbalances, monetary policy, and competitive pressures in financial markets.

In particular, the consequences of financial liberalisation for developing countries were always in serious dispute. Despite the predictions of 'standard' economic theory, empirical research revealed that net capital flows to developing countries over time mostly flowed 'uphill' from poor to developed economies, with

(fortunately) foreign direct investment as a major exception (Prasad et al. 2007). If one adds to this 'Lucas paradox' (Lucas 1990) the 'original sin' account of the frequency of crises in emerging market economies (Eichengreen and Hausmann 2005) then it was highly likely that capital market integration would develop as an erratic system, potentially destabilising for exchange rates and other macroeconomic variables, and often costly for economic development.

While there were identifiable longer-run benefits to financial openness, these might require considerable and successful institutional development and governance if the benefits were to be realised properly (Kose et al. 2006). The clear conclusion was that financial openness would most likely turn out badly if insufficient attention were to be paid to governance and if there were to emerge an over-reliance on the market as the core mechanism of the system. Evidence for the contrary view became thinner as time went on.

Lesson 2: Constraints on Policy Space and Dilemmas of Cooperation. This institutional fabric of financial governance must be consciously developed. Cross-border market integration would require substantial levels of international cooperation if national policy goals were to be achieved, while cooperation necessarily involves a delegation of national prerogatives to the international level. There is thus a tension between the constraints that financial openness places on national policy space and the necessary compromise of the same that flows from the cooperative solution. The dilemma is what Cohen has called the problem of the 'Unholy Trinity' (Cohen 1993, 1996, 90–4) based on the long-standing work of Mundell and Flemming. Capital mobility can also increase constraints on the fiscal options available to governments: the redistributive and social welfare policy choices crucial to domestic political legitimacy, placing governments between often-incompatible global market pressures and national political imperatives (Underhill and Zhang 2003; Rodrik 2007). In addition, national supervisory and regulatory policy frameworks would face adaptation to the operation of cross-border financial markets, requiring the resolution of conflicts of interest and cross-national institutional differences.

Lesson 3: Skewed Policy Input. Perhaps more important was how demands for new forms of international financial governance initially emerged and were adopted as policy. Financial firms and their associations have historically close and relatively exclusive relationships with elite state policy-makers and with the key international organisations together responsible for the design of the reforms. As argued in section one, there was already a private sector-state agency coalition in favour of a market-led approach, the policy preferences of which was observable in the norms and rules of the new architecture. Ideational adverse selection was skewing financial governance to the preferences of those best placed to influence decision makers: the financial sector and their elite state agency interlocutors. Given the technical nature of the issues under scrutiny, these policy inputs were not always open to broad debate in government or by the public. Research findings indeed pointed out that G7 governments generally backed the preferences of their corporate financial sectors (Baker 2005) in an increasingly transnational policy community (Underhill 1995; Tsingou 2014).

Lesson 4: Policy Rent-Seeking and Capture. This brings us to the fourth cautionary tale that was reflected both in the literature and on the ground. The problem of narrow, exclusionary policy communities that generated the international financial architecture is anchored at the domestic level of the countries that host the principal financial centres. Skewed policy input resulted in skewed ideas that produced in turn an imbalance of public versus private authority and interests in the fashioning of both supervisory/regulatory policy and the financial order itself. Financial liberalisation and market-based approach to financial governance constituted a process of policy-rent seeking which yielded important competitive advantages for the major international investment banks and financial conglomerates who pursued the policy in the first place. This meant that agency independence and accountability would be crucial to the provision of financial stability (IMF 2002), but state agencies involved in financial governance also had a crucial interest in financial liberalisation and frequently made common cause with the financial sector.

In short, there was a classic problem of ‘capture’ that is thoroughly debated in a wide range of policy studies, law and economics, and regulation literature (Bernstein 1955; Stigler 1971; Peltzman 1976), including in relation to the financial sector (Barth et al. 2006; Hardy 2006). While ‘capture’ does not mean that private interests always get their way (Young 2012), in the pre-crisis period it extended from domestic to transnational decision-making and involved complex interactions with the process of policy reform aimed at the achievement of financial stability. Baker (2010, 650–4) has argued that this multilevel process worked through a combination of four principal mechanisms: i) traditional industry lobbying; ii) the low political salience of financial stability issues in boom times; iii) the constant rotation of elite personnel between public and private sector appointments or ‘revolving door’ that underpinned the emergence of a shared policy agenda or ‘culture’; and iv) the frequently common educational background of this same public-private elite and the development of shared cognitive assumptions about the functioning of financial markets that constituted an ‘intellectual’ dimension of capture or ‘groupthink’.

2. Private Power and ‘Governance Light’: The Pre- and Post-Crisis Reform of Financial Architecture

A brief examination of the emergence of the pre-crisis financial architecture provides contextual background to the cases in section three. These well-understood lessons were ignored and alternative market-based ideas embraced despite the growing evidence of instability correlated to financial openness combined with ‘governance light’. The starting point is once again the adverse selection of ideas in the policy process: that financial and other forms of globalisation served material interests by providing (unequally-distributed) benefits or these trends would not have happened, especially given the very real costs (Rodrik 1998; Williamson 2003). Crucially, the emerging system offered competitive and other material advantages to those that proposed it in the first place.

The response was ‘new’ financial architecture that sought better to adapt national policy frameworks to the requirements of financial markets. The financial architects

of the 1990s reversed the approach taken at Bretton Woods in 1944: instead of adapting international order to the requirements of national democracies, the focus was on adapting and strengthening the developing and emerging market economies to the pressures of a market-based and integrated global financial system. These policy-driven constraints were added to the constraints on national autonomy of capital mobility and the costs of episodic financial crisis. Volatile capital flows were seen as constituting useful pressure to develop sensible norms and standards to underpin macroeconomic policy compatible with the global market system.

A major plank in the reform process was the promulgation of a range of 'global' standards in the domains of macroeconomic policy, financial stability and regulation, accounting and corporate governance to which emerging markets and poor countries were to adapt (Tirole 2002, 18–22). If the sensible rules were properly applied, the market would function in a stable manner. New consultative forums emerged to provide better overview and supervisory coordination of globally integrated markets (Basel Committee; Financial Stability Forum or FSF—recently renamed and strengthened as the Financial Stability Board or FSB). Yet none of these bodies had real power to set rules for global financial governance; implementation remained domestically rooted. A number of private sector initiatives were also developed, aimed as much at pre-empting more robust public intervention as they were attempts to fill gaps in governance (Helleiner 2009, 117 and *passim*).

The new institutions also functioned generated skewed policy input. Decision-making bodies such as the BC and IOSCO were characterised not only by exclusive policy communities, but also by virtual separation from accountable political processes (Underhill 1995, 1997), a problem further exacerbated by frequent recourse to self-regulation. Global finance became increasingly regulated by agencies constituting regimes that were more responsive to private interests and their ideas than to providers of collective goods (Cerny 1996, 96–9; Porter 1999). Evidence indicates that crucial multilateral IFIs, such as the IMF, were part of this constellation of interests (Wade 1998; Stiglitz 2002). Private institutional investors attempted to shape the investment environment in emerging market economies by pressing these countries to adopt policy frameworks favourable to their interests (Maxfield 1998; Porter 1999), even though such policies might exacerbate problems of economic development and socio-political stability. The emerging system of financial governance across national and global levels was thus flawed in important ways in terms of input-side, policy-process legitimacy.

Perhaps more important is how demands for new forms of international financial governance initially emerged and were adopted as policy. The Basel II supervisory accord was perhaps the best example of the problem. The process through which B-II was formulated was a second example of policy rent-seeking by financial sector constituencies and policy networks seeking liberalisation and lower regulatory charges. In these networks, private market interests found respondents in finance ministries and central banks and have thus been able to shape policy at the global level. The final rules and standards sanctified by B-II tend to award competitive advantages to powerful market players with little regard for either their smaller (systemically less significant) competitors or developing and emerging market

economies (Claessens et al. 2008). The bottom line is that private actors, in particular large internationally active financial institutions, had more influence on pre-crisis financial architecture reform than developing country members of the Bretton Woods Institutions. This is all too reminiscent of the conditions of regulatory capture as outlined in the literature.

To conclude this section, regular episodes of financial crisis in the 1980s–90s exposed the risks to firms and national economies of a liberal financial order. No one denied the need for better national-level governance and greater levels of cooperation at the international level. Skewed inputs dominated by private preferences yielded a process of ideational adverse selection that became institutionalised, systematically producing dysfunctional outcomes despite an appearance of ongoing reform in reaction to periodic crises. The reforms produced a crisis-prone system of ‘governance light’ that delivered material advantages to those who had proposed it and unduly constrained the policy space available to the very governments in whose name it was promulgated. As the system became more institutionalised, ideas, interests, and outcomes were locked-in as ‘normal policy-making’. Path-dependency had established itself and reform occurred through what Hall identified as analogous to Khunian first and second order change (Blyth 2013; Hall 1993, 279; 281–3).

The literature had forewarned policy makers representing the public interest of these problems. Ideational adverse selection ensured that policy-makers and private interests chose to award themselves material advantages by sharing arguments in favour of financial integration and market-based regulatory governance, putting other people’s money and future at serious risk. Policy capture ensured that reform went awry.

Ultimately the costs of the system were born by poor country and developed country citizens alike through the public rescue of the banks and the recession that followed. The lesson is that well-placed private interests win out against common sense and scholarly understanding and also win out against the dispersed and unorganised interests of the general public unless specific measures to prevent such an eventuality are positively developed, shades of Mancur Olson (1971). This outcome again should not surprise us and we were so warned by Adam Smith 238 years ago: ‘People of the same trade seldom meet together, even for merriment and diversion, but the conversation ends in a conspiracy against the public....’ (Smith 1937 [1776], 128). The inherent interest in financial stability of those who ultimately bear the risks and pay for policy failure should be reflected in the content of policy. As Louis W. Pauly (1997) asked some time ago, *Who Elected the Bankers?*

3. Case Studies of ‘Governance Light’: The Basel-IOSCO Nexus through to Post-Crisis Reform

According to the ‘punctuated equilibrium’ model of ideas and the policy process, the combination of the pre-crisis evidence plus the enormous shock beginning in 2007–08 should have proven a clear alibi for a ‘third order’ paradigm shift in the policy approach (Hall 1993). Blyth (2013) elaborates further on the conditions for a third-order paradigm shift in policy approach under the potentially

transformative pressures of a major crisis and relates this to the post-crisis 'stickiness' of ideas. To determine the extent of change, this final section examines two cases of global level standard-setting in financial market supervision and regulation: the Basel Committee on Banking Supervision and IOSCO. These two cases are selected as crucial and representative of the broader context sketched above: first because of their central importance to the emerging global financial architecture, and secondly because the financial governance functions involved have migrated out of the national domain and developed multi-level, indeed global-level characteristics. Thirdly, both banking supervision and securities regulation have traditionally involved public-private sector interaction at the domestic level in the post-war period, and the transnationalisation of each policy process allows one to correlate the emergence of multi-level governance to observable shifts in the balance of public vs. private authority in the policy process. Fourthly, there are huge material advantages at stake, coupled with enormous socialised costs should things go wrong, if this public-private policy community should succeed in developing a path-dependent shared agenda that limits policy options to their own skewed idea-set. In short, these cases are ideal laboratories for observing ideational adverse selection at work.

First the analysis of the two previous sections will be applied to each of the cases. The pre-crisis system for each case will then be compared to the post-crisis reforms to support the main contention of this article: that policy failure endogenous to a pre-crisis regulatory coalition has so far failed to disturb the tenacity of material interests and therefore the ideational inertia of institutional path dependency. Despite the emergence of ideational competition from the new 'macroprudential approach' to financial governance, the market-based approach remains intact. The reforms contained in B-III are still applied in a price- and 'risk-sensitive' market-based framework with no adequate mechanisms for genuine system-wide application or monitoring. If this is the situation so far, of course the reform process is incomplete and new departures may yet result. This issue will be addressed in the conclusion.

(a) International Banking Supervision

The Basel Committee provides an example of how cross-border integration and emerging transnational policy processes have rendered private agents more influential than many sovereign members of the global financial system. Founded in 1974 (see Wood 2005), the BC gained a reputation for 'Olympian' detachment as guardian of the public interest, secretive and apparently well insulated from public and private influence. The 1988 Capital Adequacy Accord (B-I)¹ was the crowning achievement (Underhill 1997). Yet this apparent insulation at the international level from traditional lobbies obscured a more prosaic reality. National financial policy communities, with central banks and autonomous regulatory agencies at their core, were often characterized by 'business corporatism' and the delegation of public authority to private agencies via self-regulation (Moran 1986; Coleman 1996). This close relationship between regulatory agencies and their constituencies combined with delegation is arguably enhanced by the insulation of central banks and other relevant autonomous agencies from the rough and tumble of traditional

policy-making in democratic governments. Thus these agencies develop policy in close cooperation with a small community of private interests which shared more with their official 'principals' than with other sectors of the economy and society.

Nonetheless, cross-border market integration meant that via B-I, the regulatory bargains reached at the national level had to be adapted with necessarily distributional consequences that in turn led to calls for more BC consultation with the private sector, especially with the Institute for International Finance (IIF) based in Washington.² This at first informal consultation process began when the IIF issued a position paper (IIF 1993, 3) sharply criticizing the 1993 the BC's proposals to amend B-I to include bank securities market risks (BC 1993). The pressure yielded results as two consecutive new BC consultative documents *embraced the approach advocated by the IIF* (BC 1995).

Following the successful translation of IIF preferences into Committee policy (BC 1996), the IIF-BC relationship became regular practice as the Committee began to consider a new capital adequacy accord (B-II) in the face of ongoing criticisms of B-I treatment of credit (lending) risk, which had remained unchanged. A Group of Thirty (G30, a private think-tank-like body) study group report on systemic risk in the changing global financial system (G30 1997) proposed that internal corporate risk-management controls should play a central role in the supervision of financial systems. 'Core' financial institutions would themselves accept the responsibility to improve the structure of, and the discipline imposed by, their *internal* risk management mechanisms (G30 1997, ii; 12). In 1998 the IIF issued its own report specifically urging the BC to update B-I on the basis of banks' market-based internal risk-ratings and measurements of market exposure (IIF 1998). This approach became accepted with little critical analysis by either public or private authorities when the final accord was reached (BC 2004).³ Here lie the origins of the market-based supervisory approach contained in the three pillars of B-II⁴ and that was *already* functioning in relation to bank 'trading books' under the 1996 amendment to B-I.

The long-institutionalized relationship between regulators and the regulated in financial supervision had developed at the transnational level by the mid-1990s, and B-II was derived directly from an ideational and policy agenda set by proposals from the private sector. The new accord put forward three approaches implementing the IIF and G30 proposals from which supervisors could choose according to the profile of the bank in question: i) a 'standard' approach that could apply to all banks; ii) a 'foundation' and iii) 'advanced' Internal Ratings-Based approach (F/A-IRB). In both IRB approaches, a bank's own internal risk-ratings model determined (in relation to shifting market conditions) both the value-at-risk (total market exposure) and the level of risk attached to specific loans. In the A-IRB version, with supervisory approval of the bank's internal risk management system, all aspects of credit risk were estimated by the bank itself. In this way, both credit risk and the risks attached to securitised assets came under the market-based supervisory approach adopted by the 1996 amendment.

A claim that the BC in the mid and late-1990s was subject to capture appears largely justified, particularly the 'cognitive' and the revolving door/institutional design aspects thereof (Baker 2010, 650–4). It is therefore not surprising that the

distributional advantages of the new system accrued to those large banks permitted by the accord to operate under special circumstances the advanced internal rating-based approach (banks that incidentally *also* posed the greatest degree of systemic risk). According to the BC's own estimates, users of the A-IRB approach would tend to lower the regulatory capital and reduce the cost of lending operations relative to those using the 'standardised' approach *by over 25% in some cases* (BC 2006, 5–15; Tables 5 and 6), and banks (and clients) using the latter would find their capital reserves more likely to rise, hurting their competitive position.⁵

B-II thus implied a clear relative cost disadvantage for both rated and unrated banks specialising in lending to (low-/unrated) SMEs. In this sense, the new approach had the signal feature of permitting the 'too-big-to-fail' institutions to hold less capital. The effects of Basel II were therefore known to be skewed by the BC's own admission. Indeed there was much doubt that B-II would enhance the safety and soundness of the financial system it was supposed to protect.⁶ 'Market prices should never be employed as a solution to the problem of market failure,' warned Avinash Persaud (2000), head of State Street Bank and winner of the IIF international finance essay competition in 2000. Instead, any system of prudential supervision should be *counter*-cyclical, attenuating what might constitute a bubble and stemming the tide of panic in a downturn, or 'leaning against the wind' (Goodhart and Persaud 2008). Warnings there were (e.g. Rajan 2006), but the proposals remained largely intact at the point of implementation. The crisis tells us that the system either did not or perhaps could not work.

Basel since the Crisis. Since this time, the Basel III accord (B-III) has emerged as the centrepiece of the post-crisis reform effort that has preoccupied the BC. The process began with a hasty revision of B-II in 2009 and led to the publication of a series of B-III consultative documents (2009–10) and the final version in December of 2010, in turn revised in June 2011 (BC 2011b).⁷ BC Chair Wellinck (who stepped down in 2011) claimed that the new agreement comprised 'a comprehensive set of measures' (BC 2011a, 2).

There are indeed significant changes that can be understood by examining the BC's report to the G20 summit on the crisis fallout (BC 2010d) and B-III itself (BC 2011b). B-III is portrayed as the first of the building blocks of a 'broad strategy' for a 'new approach' to the post crisis financial system that has a number of aims (BC 2010d, 1–2). B-III indeed claims to introduce a,

... macroprudential focus, addressing system-wide risks that can build up across the banking sector as well as the procyclical amplification of these risks over time. Clearly these micro and macroprudential approaches to supervision are interrelated, as greater resilience at the individual bank level reduces the risk of system-wide shocks (BC 2011b, 2).

Despite these claims, an examination of B-III and subsequent documents that elaborate on crucial details and its implementation (e.g. BC (2010a, 2013b in references) and FSB 2013) reveal that the market-based approach has not been abandoned in favour of anything else, and Basel III on the contrary builds *directly* on

the approach developed in the 1996 and B-II frameworks. The new package consists of several innovations: a higher *quality* and *level* as well as *scope* of capital adequacy requirements, and five 'macroprudential' elements. These will each be dealt with in turn.

Capital Requirements. Concerning bank reserve capital, there is a more rigorous definition of 'Tier 1' capital (essentially limited to common equity and cash/retained earnings), and the B-II level is raised from 4% to a 6% *risk-weighted* minimum (6–7.5% with the new discretionary countercyclical capital buffers—BC 2011b, 57–8, see below), although total Tier 1 plus Tier 2 is still the same 8% in total (BC 2011b, 12) as for B-I and B-II. Furthermore, 'risk coverage' has been extended (BC 2011b, 29–51): banks will be required to hold capital reserves on all market segments and entities in the conglomerate (derivatives, shadow banking, SIVs/special-purpose entities etc.), the full range of counterparty risk, and a review of the supervisory treatment of the 'trading book' was undertaken that remains in progress (2013c). Tighter review and monitoring of bank risk management models, including 'black swan' stress testing, would also be pursued. In addition, the *definition* of what constitutes capital, risk-weightings, and the new liquidity provisions have been harmonised globally to prevent regulatory arbitrage.

However, there is no essential change in the system itself: large 'sophisticated' (often systemically significant) banks may still apply these risk-weightings at their own discretion through the A-IRB approach, and market price signals and internal models remain central to the estimation of both risk *and* asset exposure. Asset risks can still be netted against each other in the bank's trading book. This means that a 6% minimum is only 6% if all bank assets carry an average of 100% risk-weighting; meanwhile, the measure of Tier 1 capital remains highly procyclical. Furthermore, prominent officials and economists have criticised these levels of capital as inadequate. Miles et al. (2012, 26) argued that capital ratios should be 'at least twice as large as' those agreed in B-III. These findings were echoed by UK-FSA Chairman Adair Turner: capital requirements should be 'far above even Basel III levels, something more like 15–20% of risk-weighted assets' (Masters in *Financial Times*, 16 March 2013; Haldane 2011; Turner 2011; Admati et al. 2013, 6–8 and 53–60; Helleiner 2014, ch. 4). Alarming, the economists Boone and Johnson (2011) have claimed that the levels of capital required by Basel III of systemically important financial institutions are 'no higher than that reported by Lehman the day before it failed';⁸ likewise Haldane (2011, chart 5) demonstrates that both 'crisis' and 'no-crisis' banks had 'largely indistinguishable' levels of Tier-1 capital only days before the Lehman failure.

Further criticisms hit at the very nature of the system of models and risk-weighted capital standards. The BC (2009b, 2) stated boldly that prior to the crisis 'banks could hold as little as 2% common equity to risk-based-assets, before the application of key regulatory adjustments.' B-III has done little to improve the situation: model error means that calculating Tier-1 levels were 'as much an article of faith as fact' and could 'equate to several percentage points in capital (Haldane 2011, 4–5).' A recent European Banking Authority study of 89 banks found that *up to 50% of the*

differences in capital charges calculated by banks were likely due to differences in models, and not due to differences in the nature of the respective assets or portfolios themselves (EBA 2013, 6–9)! So the system still provides banks with too much scope to inflate capital ratios ‘through the redesign of transactions in order to lower capital requirements—rather than a genuine increase in loss absorption capacity (BIS 2013, 55-6).’ And such a practice, it should not be forgotten, represents an ongoing and considerable material and competitive advantage for banks permitted to use the A-IRB approach. The most recent BIS *Annual Report* (2013, 59–65) went on to analyse the deficiencies of a model-based risk management system and to recommend a multifaceted response.

For all this publicly-available scepticism about both the market-based system of supervision and the adequacy of the new B-III capital standards, banks and representative associations did not hesitate to lobby hard in their own material interest: *for* the preservation of the market-based system, *for* the general idea of higher quality and levels of capital, but *against* the Committee’s initial (consultative) B-III proposals (BC 2009b) as too stringent and too soon. Evidence of industry influence essentially continued to reflect all four aspects of Baker’s ‘multilevel regulatory capture’ (Baker 2010, 650–654) but here the direct lobbying and ‘revolving door’ aspects were perhaps most relevant. The effort began pre-emptively,⁹ and focused on three central points:¹⁰

- (1) Stringency: the new levels were too high,¹¹ and therefore might undermine their objective of greater financial stability.¹² Small banks and SMEs mostly argued against the ‘one-size-fits-all’ aspects of the proposals, claiming the standards were too high for them, and sometimes therefore by implication too low for SIFIs.¹³
- (2) The cumulative impact on financial markets and the macroeconomy would be (highly) negative.¹⁴ Official sector and independent analysts contested the extent of these claims and argued that there may well be net benefits (despite some increased costs) given that the offsetting cost of crisis was substantial to say the least.¹⁵
- (3) Therefore, the measures must be watered down and spread over a lengthy transition period, preferably delaying implementation until banks and the economy had recovered.¹⁶

In the end, bank and other pressures successfully achieved a major delay in the implementation of B-III from end-2012 until 1 January 2019 (Persaud 2010; Blom 2014),¹⁷ and lobbies were also successful at some minor watering down of the capital standards, particularly in the EU (Lall 2012, 628–9; Howarth and Quaglia 2013; Blom 2014). The long transition period left lots of room for further bargaining over the implementation of the new standards. There was never much danger that the risk-weighted VaR approach would be abandoned. As Tarullo (2008, 262–3) predicted, having invested so heavily in the approach, the BC would be unlikely to give it up, especially with the strong support shown by the largest banks and supervisors in particular. As has been argued here, it was part of a shared public-private ideational and policy agenda.

Macroprudential Elements. There are essentially five elements to B-III and subsequent documents that have been associated with an emerging 'macroprudential' approach to financial supervision. The first is the 'capital conservation buffer' (BC 2011b, 54–7) and the 'countercyclical' capital buffer and (BC 2011b, 57–60). The former 'is designed to ensure that banks build up capital buffers outside periods of stress which can be drawn down as losses are incurred;' (54), at least 2.5% above the 6% Tier-1 minimum. The latter is more properly 'macroprudential' and represents 'leaning against the wind' in the financial market bubble-burst cycle (BC 2011b, 5–7). A modest countercyclical buffer of up to 2.5% will be required when it is judged that excess credit growth heralds a rise in systemic risk. None of this is beyond the VaR model manipulation margins identified by analysts cited above (Hellwig 2010; Haldane 2011; BIS 2013, 55–6), and represents no departure from the market-based approach to supervision because it remains applied on a microprudential per-bank risk-weighted basis. Most problematically, the buffer is implemented at the discretion of national authorities (leaving room for eventual inconsistency, not to mention cross-border arbitrage by banks). Despite commitments to cross-border co-ordinated monitoring, there is nothing in place to take a genuinely 'global' systemic view of credit conditions and their relationship to other aggregates such as asset prices. Internationally active banks are to apply a 'weighted average' of the buffers in jurisdictions in which they have exposure; how this applies to market instruments is not entirely clear (BC 2011b, 59). The measure has eventual 'macroprudential' potential but does not yet represent the dawn of a new approach; it remains an extension of the Tier-1 capital ratio.

Secondly, there are the measures in relation to Systemically Significant Financial Institutions (SIFIs; see BC 2011b, 7–8; 2012; 2013d) that impose 'loss-absorbing capacity beyond the minimum standards (BC 2011b, 7).' Depending on their relative size (so-called 'buckets' 1–5), from 2016–2018 global SIFIs will hold between 1–3.5% additional Tier-1 capital relative to risk-weighted assets (BC 2013d, 12); this will be treated as an extension of the capital conservation buffer and provides some incentives against bank growth. The measure of course employs a risk-weighted methodology, and the extent to which the measures operationally remain at the discretion of national supervisors (Pillar 2) or are part of Pillar 1 bank risk internal management is unclear.¹⁸ Time will tell when the measure is phased-in from 2016.

Thirdly there is to be a Liquidity Coverage Ratio or LCR (BC 2010a; 2013f) designed to ensure that under short-term financial stress, banks have enough unencumbered 'High Quality Liquid Assets' (HQLA, in effect, cash) to cover 100% of their expected net cash in/outflows for one calendar month. This measure attracted particular attention from financial institutions in their comments on the first draft of B-III and the details of the liquidity ratio.¹⁹ In their lobbying efforts, the IIF and EU banks have managed to expand the definition of high-quality assets (Blom 2014; Lall 2012, 631; Howarth and Quaglia 2013, 341–2).²⁰ Of course, even high quality assets can suddenly deteriorate in value, and it is not clear what happens if, as is very possible, financial stress becomes generalised and lasts more than one month; the ratio remains predicated on a prediction made in 'good times'. How 'macroprudential' this measure is, applied per bank and not systemically, is very

unclear; it is effectively an extension of 'stress testing' of banks against downturns in the market.

The LCR is supplemented by a fourth measure, the related Net Stable Funding Ratio (NSFR) that also pertains to liquidity management in individual banks, but covers a one-year time horizon. It is aimed at pushing institutions 'away from short-term funding mismatches and toward more stable, longer-term funding of assets and business activities (BC 2010a, 25).' Unfortunately, controversy with the industry over this measure²¹ has led to it being dropped from the latest BC document on liquidity coverage (BC 2013f, 1) and its future remains unclear despite a commitment to a 2019 deadline. If ever implemented, banks will be required to estimate their net funding requirements for the coming year, and to make stable and unencumbered provision for at least 100% of this net amount. Like the LCR, there is nothing genuinely systemic about this measure, applied as it is microprudentially, (though potentially in a framework of systemic monitoring of credit conditions). But it should, if implemented, help banks deal with extended periods of stress when they occur by relieving pressure on short-term interbank and money market funding. The countervailing danger is that *both* liquidity measures prove highly procyclical in an asset-sale scramble for funds.

The fifth and arguably most important tool in the alleged 'macroprudential' armoury is the proposed new and internationally-harmonised 'leverage ratio' (BC 2011b, 4; 61–63; BC 2013a). The aim is to constrain the micro-level (individual banks) and systemic build-up of leverage, attenuate de-leveraging in times of distress, and provide a solid 'backstop' reinforcement of the capital standards (BC 2011b, 61). This 'simple, transparent, non-risk-based leverage ratio' (BC 2013a, 1) has been promoted as a step *outside* the risk-weighted paradigm of the market-based approach to financial supervision and as a principle evidentiary exhibit of a third-order paradigm shift in the ideational framework towards a macroprudential approach (Baker 2013a; 2013b). The strenuous objections of the industry to the proposal, particularly in Europe, might convince one that this measure was indeed such a departure. For example, BNP Paribas found the first version of the proposal (BC 2009b) to be 'extreme ... no clear objective and justification.' This was echoed by the Swedish Bankers Association: 'We strongly oppose the introduction of a non-risk-based measure such as the leverage ratio ...' with similar objections coming from the Dutch and Danish Bankers Associations; the European Banking Association, and the IIF among others.

Closer examination of the details demonstrates that this claim of a new departure is at best only partially true. As a ratio, the proposal consists of two elements. The denominator is 'total exposure' (both on- and off-balance sheet) of the financial institution. This exposure measurement cannot be netted and cannot be risk-weighted (BC 2011b, 61–2) and therefore its value only varies with business activity of the bank and market volatility. Most attention has been paid to the presumed one-way effects of this denominator on bank behaviour. The numerator, however, *consists of Tier-1 risk-weighted capital as defined in B-III*, and we know furthermore that choices in terms of exposure are influenced by their effects on the level of capital. So the ratio remains by definition market-price sensitive, and therefore prey to the very 'redesign' the BIS warned about in its 2013 annual report (BIS

(2013), 54–5; 59–64; also Miles, Yang and Marcheggiano 2012; Hellwig 2010). The link with risk-based approach is not broken and the fixed 3% ratio, ‘the average of three month-end ratios over a quarter (BC 2013a, 2),’ is effectively endogenous to the necessarily procyclical variations in capital and is applied microprudentially on a per bank basis.²² Furthermore, industry lobbying has scored some serious points: the 3% level has now been reduced to the status of a testing and monitoring exercise 2011–17 (BC 2011b, 63; Blom 2014), with the final level to be determined as a result. The latest version of the proposal permits accounting consolidation of the exposure measure (BC 2013a, 2) while Howarth and Quaglia (2013, 336) claim that industry pressure also led to EU legislation limiting the role of the leverage ratio in risk management. Although leverage has been reduced below the pre-crisis levels across a range of banks (BIS 2013, 55), the proposed ratio is still low in historical terms (Admati et al. 2013, 55–6) and also arguably low in terms of safety and soundness, permitting banks an exposure of 33 times capital. As Thomas Hoenig (former US Federal Deposit Insurance Corporation vice-Chair) pointedly remarked, ‘you can game Basel II and Basel III, and the fact is they are gamed in every instance.’²³

Other Measures. The new framework will have further building blocks in the future and may as a consequence evolve closer to some macroprudential ideal. There is the ongoing ‘fundamental’ review of the ‘trading book’ (latest version in BC 2013c) and of the role and use of external Credit Rating Agencies (CRAs) ratings in banking supervision (BC 2011b, 4). The standards of supervisory review and systemic monitoring will be improved in tandem with bank disclosure requirements, and cross-border consistency will be improved through what is known as the Regulatory Consistency Assessment Programme (RCAP, see BC 2013b, 2013e; also FSB 2013 and Joint Forum 2012, 10–12, re cross-border conglomerates). In other words, the new system will attend more robustly to systemic risk problems and stress in individual financial institutions, linking up with the work of the new Financial Stability Board and Joint Forum of Financial Supervisors (insurance, securities, and banking) likewise based in Basel. The final version of the *Core Principles on Banking Supervision* (BC 2012) indeed places more weight on the issue of identifying and the timely management of systemic risk and attending to the macroeconomic context,²⁴ as well as on better supervisory co-ordination across borders and market segments. Although little has been said since the original BC report to the G20 (BC 2010d, 2), a set of FSB recommendations on the promised institution of ‘Colleges’ of supervisors to enhance co-ordination is pledged for the end of 2014 (FSB 2013, 9).

Conclusion: Basel Committee Reforms. There are persuasive arguments that the new B-III standards are too low and are overly subject to manipulation. It seems incontrovertible that industry influence was partially successful in watering down the reforms. Clearly there are attempts to move away from market sensitivity and risk-weighting, but these are too modest to qualify as anything approaching third order paradigm ideational change. So far they potentially blunt somewhat the pro-cyclical bias of the Basel system but have as yet no comprehensive institutional framework for implementation, certainly not at the global level. All the proposed macroprudential measures are either applied solely in a ‘microprudential’

bank-per-bank manner, in the absence of genuine systemic or cross-border monitoring and measurement, or they are at the discretion of national authorities and are therefore subject to regulatory arbitrage should the national supervisor even implement the measure in the first place. The reforms therefore cannot hide the fact that the basic B-II framework and market-based system of supervision remains in place, albeit attenuated, and remains based on national systems of supervision. There is no serious institutional innovation beyond the (as yet undefined) proposal to set up supervisory Colleges to enhance supervisory coordination, and there is so far no institutionalised link between macroeconomic policy-making and financial system supervision to accompany the countercyclical measures. So far the G20/BC and/or FSB have proposed nothing along lines of a 'Volcker rule' or UK-style ring-fencing that would prevent commercial banks from drawing on their own or depositors' resources to feed proprietary trading or other activities in securities affiliates or subsidiaries or other 'related parties' as the jargon goes. Such more radical national level reforms may yet make up for some of this inertia (for a list, see BIS 2013, 57–8) but will not resolve the inherent regulatory fragmentation and arbitrage problems if global efforts remain as cautious as is now the case. In short, if more substantive reform is to come, the signs of it remain faint.

In effect, there is no 'third order' change commensurate with the promise of the much-announced 'macroprudential' turn, at least not yet. As Helleiner puts it, 'In this more restricted form, macroprudential ideas in fact provided policymakers with a perfect cover for responding ... in a manner not too radical from the standpoint of the financial sector' (Helleiner 2014, 128). The industry did not need to lobby on anything other than the details to achieve this result: the policy community selected what best fit the ideas and interests they understood (Tarullo 2008, 262–3). The ideas are still there because the public-private club that shares them, with their informational advantages (Barth et al. 2012, 10) remains undisturbed. Even its proponents accept that the macroprudential approach was highly contested, especially as concerns just how far it should go (Baker 2013a). As Barth, Caprio and Levine have boldly asserted (Barth et al. 2012) 'regulatory bias is a natural human manifestation of the current institutional structure of financial regulation (9) The proper design of financial regulation depends on the degree to which institutions oblige the Guardians of finance to work for the public (27).'

(b) IOSCO and Transnational Securities Regulation

IOSCO, perhaps even more than the BC, incarnates the idea of governance working through market processes and actors, supplemented by official guidance and monitoring. As market integration proceeded, so did the role of private actors in the governance of global securities markets. This alignment of securities market governance to private sector interests enhanced risks and led to the virtual elimination in 2008 of the Wall Street investment banking sector. The profits were appropriated by the corporate sector and their bonus-driven senior management and traders; the cost of imprudence was shared widely.

Founded in 1984 in a market environment in which national regulators alone could no longer cope, the International Organization of Securities Commissions (IOSCO) was central to this outcome (Underhill 1995, 265–266; 1997). The current 123

'ordinary' members are official national securities regulators, typically autonomous government agencies mandated by legislation. The membership is supplemented by 'associate' members (e.g. IFIs such as the World Bank or IMF, the OECD, EU authorities, and sub-national entities) and 67 'affiliate' members, which are self-regulatory organisations (SROs), securities exchanges, or trade associations with self-regulatory responsibilities. Affiliates do not vote but are crucial to IOSCO decision-making.

The historically close relationship between official regulators and SROs/trade associations is particularly important to the argument: most national regulators operate by delegating to SROs composed of private member firms. In the international domain, this practice becomes yet further removed from national systems of accountability. Equally significant, IOSCO works in close consultation with private international regulatory bodies as such the World Federation of Exchanges (WFE) or the International Capital Markets Association, a self-regulating association of dealers on primary and secondary international capital markets. IOSCO indeed considers itself a non-governmental international organisation (Underhill 1995, 261) and stresses incorporating industry inputs into the standard-setting process (IOSCO 2004, 14–15; 2005, 11–12; 2006, 5). Proposals are thus developed in close consultation with IOSCO's SRO Consultative Committee (SROCC, founded in 1989). Furthermore, technological and market innovations have made regulators heavily dependent on the industry expertise for the skills involved in formulating rules. This closely-knit transnational policy community constitutes a typical case of Michael Moran's 'esoteric politics' (Moran 1984), wherein an elite group works out the management of its own vital interests without wider public involvement.

In short, IOSCO members form the hub of a constellation of private industry associations and self-regulatory organisations with a private-sector membership. This increases acceptance of proposals by the industry, but it also means that IOSCO incarnates a high degree of 'soft-law' based public-private architecture (Brummer 2012, ch. 2) in a policy domain of vital public concern. Indeed, a range of IOSCO functions are outrightly delegated to private-sector associations and think-tanks such as clearance and settlement or derivatives regulation to the Group of Thirty (Tsingou 2003, 2006) or accounting issues to the International Accounting Standards Board (IASB; IOSCO 2005; Vaughan and Felderhof 2002).

The primary goal of IOSCO has therefore been to provide globally the regulatory benefits of the domestic level, chiefly by harmonising cross-border securities market regulation to reduce the costs of national differences (IOSCO 1989; 1991; 1992; 2006, 18; Guy 1992). The TC (which works in consultation with the SROCC through five standing committees representing developed country members) is the chief forum for achieving these aims (IOSCO 2006, 6–9). The Technical Committee (TC) historically consisted of 15 developed market members (Guy 1992), and now includes Mexico (since 2007), Brazil, and China (since 2011; <http://www.iosco.org>; accessed 15 February 2011).

The development of open transnational markets would arguably lead to more efficient capital markets and thus economic growth. Behind this rationale lay the advancement of private and particularistic interests and thus 'adverse ideational selection'. US investment bankers and institutional investors in saturated domestic

markets sought overseas expansion in Europe and Asia, exploiting a perceived competitive edge. Regulatory convergence to establish international (largely American) standards within the IOSCO policy community would accomplish this goal, and also enhanced the role of private interests in the transnational policy processes (Zaring 1998; Simmons 2001). In doing so IOSCO actively incorporated the proposals made by the Group of Thirty and the WFE (IOSCO 1989; 1991). The next step was the TC's work on a comprehensive 'code of conduct'. This was developed in close cooperation with the SROCC, with global private-sector associations such as the WEF, IASB and the Group of Thirty, and with market participants (IOSCO 1999). In 1998, this process produced 30 'Objectives and Principles of Securities Regulation' (revised in 2003 with a new implementation 'methodology') aimed at i) investor protection; ii) market efficiency and transparency; and iii) the reduction of systemic risks (IOSCO 2003), all with a view to reducing the risks and costs to major firms of cross-border transactions and issuance, thus accelerating capital market integration.

IOSCO formed the Securities Fraud Task Force to strengthen corporate governance (IOSCO 2005, 12–13; 2006, 6). These reforms were seen as integral to internationally acceptable principles of sound capital market regulation (Cooper 2007; IOSCO 2005; 2006), and few would argue the contrary. The TC essentially designed the standards, and while the Emerging Markets Committee (EMC) played a consultative role, much of the discussion concerned the implementation and not the content of the standards (IOSCO 2005, 2006). These reforms remained consistent with the interests of private actors within and beyond the IOSCO policy community that promoted convergence on the basis of the 'shareholder value' model and whose constituents would initially benefit in competitive terms from the adjustments this would impose on others (Useem 1998; Nölke 2004).

IOSCO regards its crowning achievement to be its 2002 multilateral system of Memoranda of Understanding (MOU's). The multilateral MOU approach, which replaced a much clumsier system of bilateral deals, aimed to accelerate national agency adoption of the IOSCO *Principles* (IOSCO 2005, 8–10; 2006), and in 2005 IOSCO achieved all-member endorsement of both the Principles and the MOU system. The agreement included firm targets in terms of implementation and to expand the network of signatories by 2010. Members, affiliates, and firms alike have thus shared an ideational commitment to market-based integration and governance, playing a part in the regular outbreak of crises. As with the Basel case, the result has been most beneficial to those who designed the policies in the first place. Despite the availability of alternative idea-sets, IOSCO's efforts generated neither financial stability nor an efficient and equitable system of financial governance.

IOSCO Post-Crisis. Since the crisis, IOSCO has proposed reforms that mirror the market-based ideational agenda of previous years but with a post-crisis urgency and 'spin': revision of the supervisory principles; cross-border and also cross-sectoral (e.g. Joint Forum²⁵) supervisory cooperation; corporate governance; Credit Rating Agencies (CRAs); market transparency; accounting standards; emerging market issues; and a range of specialised market/product work such as derivatives, hedge funds, short-selling, real estate products, private equity; special purpose entities (SIVs) and so on. There were also new issues, including new technologies

in the markets and (naturally enough) systemic risk (IOSCO 2008c, 19; 2011). The organisation also added a task force on sub-prime mortgage products and markets that worked in close relation to the existing task force on CRAs. The concerns of governments and the public were clearly being addressed, but the work of IOSCO reveals little in the way of new departures in terms of governance, no institutional innovation, and no fundamental review of the nature of the financial system or its operation.

CRAs had certainly played a questionable role in the crisis and sub-prime mortgage products in particular (IOSCO 2012b). The 2004 CRA Code of Conduct was revised in 2008 better to ensure the integrity and transparency of the rating process (IOSCO 2008a) as well as investor protection, and a new report was issued on CRAs in 'structured product' markets, e.g. collateralised debt obligations/mortgage-backed securities (IOSCO 2008b). These reports and recommendations to members were only remarkable for their adherence to past practice and some renewed zeal in terms of application and consistency (IOSCO 2009a; 2009b), especially across financial market sectors (Joint Forum 2009). There was neither a fundamental review of the role of CRAs and 'external' ratings as signals in financial supervision nor much reference to the quality of CRA information and ratings. The worry was that new national initiatives might render the codes less consistent across borders. Late in 2009 somewhat more serious questions were being asked in a consultation exercise on the transparency of structured finance products (IOSCO 2009b), yet this only addressed secondary market issues and neither the rating of products at issuance nor anything to do with the fundamentals of CRA methodologies.

In 2010 the core IOSCO standards for supervisory practice (*Objectives and Principles of Securities Regulation*, the IOSCO equivalent of the BC's Core Principles) were updated but without any change of approach and little in the way of additions (IOSCO 2010a). Further work on CRAs (IOSCO 2010c) concluded that new national measures to deal with the question largely conformed to IOSCO principles, so all was well. Cross-border supervisory questions received a new and final report (IOSCO 2010b) that was a standard defence of previous practice. The one innovation was the notion that 'Colleges' or 'Networks' of supervisors might supplement the bilateral MOU approach, and that bilateral cooperation would not preclude the latter two options; regulators should avail themselves of as many of these options as were available, but no initiatives were proposed. From 2011-mid 2013 most activity concerned the growing range of technical issues involved in the regulation of securities markets and their clearing/counterparty operations.

As with the BC, there was an emerging concern for systemic risk issues. A debate clearly emerged within IOSCO as to the extent of change required on this score:

For some securities regulators, these questions highlight the failure of a broadly shared conceptual framework for securities regulation which warrants a rethink in light of the crisis. Other securities regulators argue that these questions did not challenge the pre-crisis framework while

others argue that there was no broadly shared conceptual framework before the crisis The intensity and speed with which systemic problems spread through the broader market, and the duration of those problems, highlighted the [consensus] for increasing the scope and use of traditional financial regulatory tools as well as the introduction of greater monitoring of so-called *macro-prudential* factors—that is, variables that can result in systemic risk (IOSCO 2011, 6).

The ideational and policy consensus was thus unlikely to yield much change. The TC admitted that four years after the outbreak of crisis, securities regulators had only been marginally involved in BC/Joint Forum and FSB efforts to deal with systemic risk, pointing mainly to US and EU efforts to strengthen the system (IOSCO 2011, 12). The only real accomplishment was the more fulsome inclusion in the IOSCO (2010a) *Principles* document of measures to identify, assess, and mitigate systemic risk. The Technical Committee's report on the matter (IOSCO 2011) was just about as anodyne as one could have achieved if one had set out to ignore the crisis altogether in terms of concrete measures. It identified the usual suspects (large institutions, interconnectedness, leverage, information problems, product innovation, nothing new...) and the analysis argued that the problem was *largely external to the market*:

However, the tendency for systemic risk to emerge in areas outside of securities regulators' control, such as the macroeconomic environment, means that they can arise in spite of the best efforts of regulators to create well-functioning, transparent and efficient markets that are rich in information (IOSCO 2011, 39).

And so they might make some noise about it:

In such instances, securities regulators should, sometimes acting in conjunction with other financial market supervisors, raise the risk awareness (of market participants, other regulators and legislators) so as to limit the development and accumulation of risks and thereby mitigate the impact of risks posed to the financial system (*ibid.*).

The most radical organisational shift concerning the governance of systemic risk seemed to be the following:

In particular, supervisors should put more emphasis on qualitative assessments of risk management techniques and culture within firms, rather than leaving the onus solely on the firms to comply with a series of requirements. This would prevent the exercise from becoming a mere mechanistic one by both the firms and regulators (*ibid.*, 44).

This came along with an admission that emergency action like a suspension of trading activity might be required in the face of market disruptions (48).

The report anyway remained advisory with caution the order of the day: 'The first commitment of IOSCO is to build a research capacity that will focus its initial efforts on researching systemic risk' (IOSCO 2011, 57). Given how much we already knew before the outbreak of the crisis, how much new research do we need to undertake

to conceive of a new approach (that, admittedly, might fit less well with the interests of IOSCO's core constituency)? Of course part of what is going on here is that emerging market members had been neither the origin of the crisis, nor had their markets been particularly disrupted. So there was no homogeneous constituency for the introduction of more radical reforms. Perhaps more importantly, the private sector partners of the IOSCO membership were involved in the policy debate to the usual degree. The controversial and problematic issues are being discussed, but genuine reform is being left to national members. There were no recommendations for institutional enhancements besides vague discussions in relation to the management of systemic risk. The one exception concerned the application of the 'supervisory colleges' idea to CRAs (IOSCO 2012a) to promote information sharing and 'if appropriate' cooperation. Such colleges would in no way substitute for or replace or take precedence over national agencies. The party line was simple: 'more of the same but better', and the macro-prudential idea remained poorly developed.

4. Conclusion

The analysis above represents a financial markets case of Cohen's (2008) notion of the diffusion of power from states to societal actors, in particular the major financial intermediaries. The propagation of adversely-selected idea-sets by material interest constituencies in skewed and closed policy communities was central to the story. The three central claims were developed in two case studies and support the argument that the current patterns of global financial governance, in which private market agents have demonstrated a long-run capacity to set public policy agendas, failed to provide for the financial stability or effective financial governance that was advertised by proponents. In keeping with the expectations of Hall's crisis-ideational paradigm shift, the severity of the crisis led to challenges to the nature of global financial governance itself. Yet despite the long-run availability of idea-sets more likely to produce beneficial results, there is at best evidence of first and second order change. Neither the institutional framework nor the constituents of the policy community have changed much, and until there are new inputs, path-dependency à la Hall is likely to remain the order of the day. The ongoing if increasingly questioned alignment of public policy objectives with private sector preferences raises fears that the enhanced rule-setting power of private interests may have severely undermined the capacity of public actors to formulate and implement successfully financial and regulatory policies in line with the broader public interest, a situation akin to policy capture.

Of course it could be (and hopefully is) a matter of time (Baker 2013a) as policy experimentation and potential failure will continue (Blyth 2013). Popular pressures may also mount. Assuming an eventual shift in inputs to the policy process, there are two possible changes corresponding to two quite different idea-sets. Firstly, the current dalliance with macroprudential approaches to financial supervision has potentially radical implications for both the structure and governance of global financial markets (Lothian 2012). However, our analysis of both Basel and IOSCO reveals that so far, macroprudential ideas of systemic monitoring are being implemented essentially in line with the current market-based approach to financial

governance and thus remain highly contested and contingent in character (Baker 2013a). Much more serious institutional innovation and a rebalancing of public versus private authority in financial governance would be required before one could conclude that the policy paradigm has indeed shifted significantly. It could also be the case that broad ideational shifts in relation to macroeconomic governance of the sort analysed by Hall (1993) and Blyth (2002) play out differently than those that are fought out in relatively closed and exclusionary policy communities dominated by private players, as in the two cases analysed here.

A second potential shift was highlighted by Germain (2010). The dynamics of political and regulatory reactions to the financial crisis may yet result in the 'renationalisation' of financial markets and their governance, a genuine 'de-integration' of the global financial system. The benefits of cross-border financial openness could be lost in the process. Some combination of these two alternatives is of course also possible. The macroprudential turn indeed requires the sort of reassertion of public authority that is most likely to take place at the national level, inviting potential policy dysfunctionality in the face of a liberal financial system, in turn stimulating further disintegration pressures. In any event, as has been argued elsewhere,²⁶ a change in the interest-based and thus ideational inputs into the decision-making process by reconstituting the policy community itself is likely to prove a prerequisite to a more rapid adoption of new ideas and implementation of genuinely different system of financial governance at the national and international level.

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Notes

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1. Capital adequacy refers to the amount of equity plus liquid or near liquid capital reserves a bank must put aside to ensure its soundness in the event of rapid withdrawal of deposits. Capital reserves are measured as a percentage of total bank assets, hence capital adequacy ratios.
2. The IIF was originally formed as a consultative group of major US and European banks during the debt crisis of the 1980s, and became a more broadly based organisation representing some 350 member banks worldwide.
3. Although the BC invited open consultations on its three sets of proposals for B-II, the IIF remained the principal interlocutor, and comments came overwhelmingly from financial institutions in Europe and North America, and to a lesser extent from official agencies, a few academics, chambers

- of commerce and industry producer associations; see the Committee web site section on comments on proposals at <http://www.bis.org/bcbs/cacommments.htm> (comments on second consultative document) and <http://www.bis.org/bcbs/cp3comments.htm> (comments on third consultative document).
4. The three pillars consist of i) minimum capital requirements, ii) supervisory review of capital adequacy, and iii) public disclosure and market discipline. Under the three-pillar system, bank owners and risk managers, supervisors, and market forces combine in risk management. For a more technical discussion, see BC 2003 on the so-called third consultative document.
 5. See e.g. submissions on <http://www.bis.org/bcbs/cp3comments.htm> by Austrian Banking Industry, the German *Bankenfachverband*, the European Cooperative Banks, the World Council of Credit Unions, or the Kreditilsynet-Norges Bank (Norwegian central bank) submission.
 6. Particularly the 'procyclicality' problem (herding exacerbates both boom and bust financial cycles, creating instability as bubbles merge) and the related 'aggregation problem' (good risk management by individual banks might not add up to a sound financial system). In short, the new supervisory practice might accentuate systemic instability in the market.
 7. During this period the membership of the BC was expanded to include 'G20+' countries in addition to the original membership.
 8. See also chart 5 in Haldane 2011, that demonstrates that both 'crisis' and 'no-crisis' banks had 'largely indistinguishable' (p. 4) levels of Tier-1 capital only days before the Lehman failure.
 9. The IIF (July 2009), even before the publication of the B-III new standards, pushed hard to ensure that the reforms would preserve the risk-based approach adopted in B-II and the Market Risk Amendment (21 and recommendation 7; 40 (Commitment VI)); that consultation with the IIF must remain systematic (section 2; recommendation 8); and that the impact of higher standards should be properly tested before being implemented (10 and recommendation 10). See also Blom (2014, 42–3), who also asserts that large internationally active banks pushed for the retention of the risk-weighted system.
 10. A good survey of industry and other positions on the BC proposals may be found in the April 2010 comments submitted in response to the BC 2009b B-III consultative document and posted on the BC website at <http://www.bis.org/publ/bcbs165/cacommments.htm> (Accessed 30 December 2013).
 11. Comments to the BC (source note 16 below) from the major US banks were on the whole negative (see submissions of e.g. Bank of America; GE Capital; JP Morgan Chase; as well as Credit Suisse ('proposed measures have been calibrated far too severely') and the Australian Bankers Association ('regulatory changes ... are potentially overly severe and may present an impediment for longer term growth'); US-based and influential Financial Services Roundtable ('proposals too conservative and risk averse'); among others.
 12. See comments from Danish Bankers Association; European Banking Federation; Financial Services Roundtable (US); the IIF; Morgan Stanley.
 13. Again see comments on BC 2009b consultative document, e.g. Independent Community Bankers of America, World Council of Credit Unions, World Savings Banks Institute/European Savings Banks Group; French, German, Polish, Danish and other banks/banking associations likewise raised this point. On the reaction against the standards in Europe, especially the position of German and French banks and industry, see Howarth and Quaglia 2013, 334–7 and Blom 2014, 42–3; 47–51.
 14. The IIF was once again in the lead here with an impact study (IIF 2010b, summary results 5–6) claiming that the new standards would initially reduce average *annual* GDP growth of the G3 by 0.6% (2011–15), half that in the longer run (0.3% 2011–20). In the first five years G3 real weighted GDP would decline by 3.1%, and employment for these countries would decline by nearly 10 million. These estimates were advanced *without considering the costs of financial crises*. The most outlandish claims award goes to JP Morgan Chase Research (see submission to the BC website, ref. note 16 below) whose study forecast that the impact of the measures would reduce banks' return on equity from 13.3% to 5.1% in one year, leading to difficulties in generating new capital *and raising the cost of all financial services by 33%*. See also comments from Deutsche Bank; European Banking Federation; European Financial Services Roundtable, US Bank Corporation, etc.
 15. See first the BC Quantitative Impact Study (BC 2010b, based on an end-2009 comprehensive survey of 263 bank responses assuming B-III implementation in 2011; in this study the costs were also not offset against benefits of enhanced stability). The results indicated that the impact on capital measurements was real but not unmanageable: Tier 1 capital in the largest banks would fall from a B-II measurement of 10.5% to a B-II level of 6.3%, requiring a modest increase to achieve the new requirement including the buffer of 7–7.5% (2–3; 8 (Table 2)). Cosimano and Hakura (2011) study focused on the economic impact, and found that the cost of lending for the 100 largest banks would likely increase by 16 basis points (0.16%) as a result of B-III (5), while discretionary application of capital buffers may increase that impact (6–7). The FSB/BC macroeconomic impact simulation study

- (BIS 2010, 7–8), assuming a B-II implementation period of 8 years and a total simulation period of 12, pointing out that according to the QIS study (BC 2010b), under B-III internationally active banks would need to raise 1.3% new capital, then estimated that by the end of the simulation ‘growth would stand at 0.13% below baseline,’ an average annual loss of 0.03% for the first 8.75 years, rising thereafter. Again, the costs of crises and offsetting benefits of reduced risk were not taken into account. The BC’s own long-term impact study (BC 2010c) found that the benefits of higher capital and liquidity charges in reducing the probability of crisis and associated output losses would substantially outweigh the potential output costs of the B-III measures (capital and liquidity ratios combined). Admati et al. (2013) claimed that capital requirements ‘significantly higher’ than those proposed in B-III would provide substantive social benefits and minimal to nil social welfare costs, while high equity requirements would not impair the intermediation functions of the financial sector (53–4). See Pagliari (2011) for a survey of impact study findings.
16. A range of banks, associations, and some governments lobbied for this, see the full list of submissions at www.bis.org/publ/bcbs165/cacomments.htm, e.g. Lloyd’s Bank; Barclays; European Banking Federation; Morgan Stanley; US BankCorp, and so on. See also Howarth and Quaglia 2013; Blom 2014.
 17. Compare BC 2009b (12) with BC 2011b (specifically Annex 4). There is furthermore no shortage of evidence of broader industry lobbying against financial reforms. Helleiner (2014, ch. 4) for example cites considerable evidence of resistance to reform from within the US administration as well as from US banks. Revolving-door private sector players become public officials also gave the financial industry an inside track (Barth et al. 2012, 6–7; Lall 2012, 627–8). Helleiner also draws attention to evidence of industry pressure from insider memoirs. For example, former and pro-reform FDIC Chair Sheila Bair claimed that there was not one Dodd-Frank reform proposal that (Treasury Secretary) Geithner actively supported (Bair 2012, 229). Former Hong Kong Securities and Futures Commission Chair, Andrew Sheng (2009, 391), drew attention to the ‘deafening silence’ of officials throughout the reform process on the issue of policy capture. Endless press reports and other ‘insiders’ memoirs provide further evidence.
 18. See claims that the measure was subject to a ‘guided discretion’ approach (Lall 2012, 632) and (Helleiner 2014, ch. 4) that it falls under national supervisory discretion in Pillar 2. The actual text claims there are elements of both: clearly national supervisory judgements should play a crucial role above and beyond the proposed quantitative methodology (see BC 2013d section ‘Supervisory judgement’, 9–10), but the approach remains rather ambivalent in the end (section ‘Interaction with Pillar 2’, 15).
 19. Once again, see www.bis.org/publ/bcbs165/cacomments.htm; see more specifically IIF 2009, 44; IIF 2010a, exec. summary 17–21 and esp. Annex 2 (e.g. p. 7: LCR ‘based on highly conservative assumptions that are often both rigid and unrealistic’).
 20. See IIF objections to the definition of HQLAs (IIF 2010a, Annex 2, 11–14). Compare also BC 2013f Annex 2 with the relevant sections of BC 2010a. The definition of HQLAs was broadened to include corporate debt rated above BBB-, some equity holdings (50% haircut on both of these), residential mortgage-backed securities rated above AA (25% haircut), and the definition of in/outflows was also watered down, giving some of them an effective risk-weighting as opposed to the required 100%.
 21. The IIF (2010a, 19) claimed that the ‘NSFR would impose limitations on banks that would eliminate much of their ability prudently to ... [make] credit available to the economy’ In response to the BC’s consultative document (BC 2009a), banking associations such as the Dutch, the American, the Canadian, and a range of individual banks, reacted negatively to both sets of liquidity provisions (<http://www.bis.org/publ/bcbs165/cacomments.htm>); on the success of lobbying against the NSFR measures, see also Howarth and Quaglia 2013, 341–2; Blom 2014, 47–51.
 22. The monitoring systems to determine national and global levels of financial system leverage are still being developed in BC-FSB consultations.
 23. Quoted in *Central Banking.com News* (1 May 2013, <http://www.centralbanking.com/central-banking/news/2265504/fdic-s-hoenig-blasts-basel-iii-risk-weights-as-insufficient>, Accessed 3 January 2014); my thanks to Eric Helleiner for drawing attention to these remarks.
 24. For example under Principle 16 on capital adequacy, clause 4 of the ‘essential criteria’ now reads: ‘The prescribed capital requirements reflect the risk profile and *systemic importance of banks in the context of the markets and macroeconomic conditions in which they operate and constrain the build-up of leverage in banks and the banking sector*’ [emphasis added] (BC 2012, 44). This places somewhat more emphasis on the macroeconomic and systemic aspects than the previous version, and several of the principles have received this sort of insertion (see ‘Comparison between the 2006 and 2011 versions of the “Core principles assessment methodology”,’ link <http://www.bis.org/publ/bcbs213a.pdf> (Accessed 23 February 2012)). The modalities and specific linkages with aspects of macroeconomic policy-making are yet to be worked out.
 25. Joint Forum of Financial Supervisors consisting of IOSCO, the BC, and the International Association of Insurance Supervisors, based at the BIS in Basel.

26. See Claessens et al. 2008 and the extensive analysis in Underhill et al. 2010, Introduction, ch. 16, Conclusion, and passim).

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