

Regulatory Reactions to the Global Credit Crisis: Analysing a Policy Community

Under Stress

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The global arrangements governing the activities of financial conglomerates remained largely unchallenged in the past fifteen years. A long period of growth in the banking industry, the lack of clarity on the links between finance and the real economy and of visible losers, and the overall esoteric character of global finance have all been contributing factors. This paper looks at the shifting governance framework in reaction to the global credit crisis and the developing regulatory responses at the global level. A core claim of the paper is that in order to understand financial governance arrangements and their reform, we need a notion of a transnational policy community of expert actors, which, transcending public/private distinctions, has been at the helm of policy processes. While much literature exists on the emergence of such policy communities and the legitimacy and efficiency issues associated with private authority and self-regulatory practices, we don't yet know how policy communities react to a sustained and widespread crisis. This paper provides an analysis of community reactions to the crisis at the official and private / 'best practice' levels, examining and challenging questions of private capture of the policy process; defining constituencies in global financial policy; and the de-politicization of finance and the development of 'appropriate' regulation.

Specifically, the paper is organised as follows. Starting with an assessment of the governance arrangements prior to the crisis, the paper addresses the regulatory responses to the credit crisis, including responses by the official and private sectors. It proceeds with an analysis of the discovery or rediscovery of institutional set-ups such as the Financial Stability Forum (now Board) and the G-20 and the re-evaluation of the role of the state in the provision of financial services, and the politics of financial reform, globally, where we observe opposing trends of consolidation and fragmentation at play and domestically, where recriminations and turf wars are taking place and where the bills of the crisis are being settled. The paper then looks at the effects of crisis management on the future regulatory landscape and the management of expectations. Finally, the analysis focuses on the practices and principles of the developing regulation and assesses how the policy community itself is adjusting both in its 'membership' and its economic ideas.

The paper argues that the policy community is under stress but not broken. The coherence has given way to a more adversarial debate but much of the agenda continues to be formulated by the same policy community of experts and focuses on tweaking rather than reforming the system. The key terms of the implicit contract between finance and the state(s) remain unchallenged and the special role of the financial sector is, if anything, reinforced. This is not to underestimate the significance of many regulatory shifts (most notably in the area of over-the counter derivatives products) but rather, shows the resilience of the community and its adaptability to changing circumstances in a time of acute crisis. Specifically, it shows that the governance arrangements in place at the start of the crisis have significantly affected the scope, as well as the intellectual and institutional parameters of international regulatory change. This allows us to see why the bulk of reform proposals are more about adjusting and safeguarding the system rather than instigating wholesale change and thus, why, despite the severity of the crisis and its widespread effects on the real economy across the world, the opportunity for a significant turning point in financial regulation is unlikely to be fully explored. The analysis

underscores the importance and persistence of the transnational informal network governance status quo and the continuing significance of the epistemic role of experts; that these experts have not been fully discredited by the crisis further confirms the continuing authority of the transnational policy community and highlights the limits of domestic politicization of financial regulatory issues.

Pre-crisis governance: the role of informal transnational networks

Over the past fifteen years, financial market activity and its governance have exhibited a significant degree of transnationalization and gradually came to reflect private sector interests and preferences. On the one hand, a small number of core financial institutions, mostly based in London and New York, became increasingly important in governance structures, shaping regulatory and supervisory standards. At the same time, financial policy came to be understood increasingly as apolitical, technical and detached from the real economy while an institutional framework of coordinated standard-setting developed, especially in the context of the Basel Committee on Banking Supervision (thereafter Basel Committee). It is a claim of this paper that the framework was one of informal network governance, generated through the interaction of the regulators and supervisors of core (G-10) countries, the private sector (private financial institutions and transnational business associations) and a community of experts. How did this state of affairs come about? The paper maintains that financial governance arrangements in the summer of 2007 were the product of a transnational policy community of key financial actors (from the world of global finance at large including public, private, think tank and academia), formed gradually over the past 30 years to bring much-needed technical expertise and coordination to policy-making and to address issues arising from liberalization and intensive financial innovation from the 1980s onwards.

In that sense, the approach builds on work on private authority (Hall and Bierstecker 2002; Cutler, et al. 1999). This literature accounts both for economic trends identified as the retreat of the state (Strange 1996) and the rise of international standard setting and guidance for public policy that has actually been in the hands of private interests. In demonstrating how private authority has become more and more prominent, an argument often accompanied by the view that the private and public spheres are increasingly blurred, the emphasis on private authority has occasionally tipped too far. This has been addressed in recent work, such as that of Rawi Abdelal (2007) who argues that in terms of financial liberalization, the last decades have not so much seen the rise of private authority but more the delegation of public authority to private actors. The analysis of this paper is based on a further nuance; the examination of the transnational policy community in question shows how a blurring of the public and the private in the area of financial regulation renders both the public/private demarcation obsolete, but also leads to reassess understandings of delegation in the practice of regulation. It also highlights that the financial sector is best understood as special in regulatory terms, in that the financial industry is now organized in the pursuit of its goals in a way that is qualitatively distinct from other interest groups or associations – and that it is thus important not to look at the private sector’s actorness in isolation if we wish to understand its influence.

The analysis recognizes that there are formal and informal channels of communication between public and private actors and fora which once established, serve to consolidate links and shape policy communities beyond the national level. It builds on the policy network literature (Thatcher 1998) which stresses exchange relationships, shared frameworks, closeness, informality and an exclusionary dimension, as well as conditions of diffuse authority (Stone 2008). Significantly, this policy community is understood as one which focuses on the transnational dimension (including in how it views the scope of its activities and conceives of its constituency) and generates actual policy (as in the case of Basel II); to do so, it relies on claims of expertise.

The role of the 'epistemic' has been extensively explored in the IPE literature, especially in relation to the coherence provided by the economics profession in the shaping and diffusion of policy. Compelling analyses are provided by Fourcade (2006) who looks at economics as a global profession, its links to the political elite and the resulting political and bureaucratic power and Chwioroth (2007) who shows that economic ideas and their advocates foster coherence in the policy making community. Similarly, links between the epistemic and the development of networks among the public financial policy community have been explored in Helleiner (1994) with respect to the Bank for International Settlements, Hall (2008) in relation to Central Bank authority networks and Baker (2006), who in his analysis of the G7 highlights the transgovernmentalism among the bureaucrats and technocrats of Finance Ministries and Central Banks and the extent of the internationalization of this community. The approach advocated here complements these stories by stressing that the epistemic in finance includes private actors and is compatible with recent work which underlines that transnational regulation does not necessarily emerge in a national institutional setting but can be a "collective response" of a mix of public and private actors (Mattli and Woods 2009: 7). Networks of regulators, central bankers and finance officials at the national and international (notably Basel-based) levels are understood to be operating in conjunction with key issue-specific working groups, the role of global industry associations such as the Institute of International Finance (IIF) and the functions of key individuals. In this context, the transnational policy community does not explicitly distinguish between the public and private, all the while legitimizing the role of the private sector and internalizing its preferences.

More specifically, the concept of transnational policy community is key to understanding global financial governance as it best captures the process of public and private actor interaction in the making of global financial policy, as well as the variety of settings within which this interaction takes place. The concept focuses on the expertise of community members, the stable, often formal and accepted as legitimate nature of interactions and is thus a significant analytical tool in explaining the formation of shared understanding and therefore, agreement over policy. As discussed above, the concept refers to groups of officials, public, private or academic which maintain some links with respective national systems but find their strongest (and often predominant) ties and perceived constituency at the transnational level. The officials who make up this community are mostly educated (both academically and professionally) in an Anglo-American context and crucially, have, throughout their careers engaged in 'revolving doors', gaining experience on both sides of the public/private divide (Seabrooke and

Tsingou 2009). The groups have formed gradually to bring much-needed technical expertise and coordination to policy-making and address the challenges arising from financial liberalization and innovation. These characteristics make for a close-knit and coherent community and can act as exclusionary mechanisms to alternative (and more domestically focused) understandings of financial governance.¹

In this context, not only are transgovernmental links among the dominant transnational domestic regulators and supervisors important for financial regulation but the policy role of the private sector also becomes more formalized. The community has over time exhibited increasingly similar viewpoints which have seldom failed to put private sector preferences at the forefront and move policy debates and decisions to the transnational level. This state of affairs culminated in the development of Basel II, the main formal regulatory tool in the global regulation of financial institutions, agreed in 2004 after a long period of consultation and gradually coming into effect (Basel Committee 2004). Basel 2 has been interpreted as the perfect example of regulatory and supervisory capture: its core elements benefit large financial conglomerates, requirements mirror private institution practices and innovation and its complex approaches are a clear market entry barrier; its three-pillar framework, covering minimum capital requirements, supervisory review and market discipline are suited to the needs and sophistication of financial institutions. Put differently, Basel II is an instance of over-production of financial innovation and under-production of regulatory standards.² This departs from traditional self-regulation as advanced by Moran (1991) and identifies the supremacy of risk management as a key self-regulatory and supervisory tool (as seen, for example, in the ‘invention’ of operational risk, Power 2005) while the herd behavior linked to the widespread imitation of risk management techniques (MacKenzie 2006) harmonizes practice in a market-shaping manner.

So, when observing the regulatory framework before the manifestation of the credit crisis, we see four key governance features: firstly, a norm shift on the nature of regulation, which used to be about telling financial institutions *what to do* and became about asking financial institutions *what they do*; secondly, an environment where regulatory capture appears to have taken hold and where private sector interests are fully internalized in the policy process; thirdly, a definition of financial policy as apolitical, with regulators and supervisors aligned with market participants and detached from other agencies conventionally understood as public in the domestic arena, and fourthly, a focus on transnational standard setting through semi-formal and informal governance networks. What might have started as a tale of a few select financial institutions in highly advanced financial centres came to define what is understood as appropriate regulation of global financial activity in general, as well as the appropriate mechanisms and policy locations for generating those rules. This state of affairs no doubt dampened the effect of warnings on the weaknesses of the system and restricted possible policy responses to mitigate imbalances and address regulation challenges.³

Crisis management and policy responses

So what of the response to the crisis? In the first phase of the crisis, up to the summer of 2008, responses were characterized by a certain degree of complacency and were broadly two-fold. The first type of response was a case-by-case approach to the predicaments of individual financial institutions, such as the bail-out and eventual nationalization of Northern Rock in the U.K., the Fed-supported buy-out of Bear Stearns by JP Morgan Chase in the U.S., and the bail-outs of Sachsen LB and IKB in Germany. The second type of response was in a systemic context, wherein central banks injected liquidity and key standard fora, such as the Financial Stability Forum (FSF), produced recommendations on 'Enhancing Market and Institutional Resilience' (FSF, 2008). The industry itself exhibited some humility with the publication of an IIF report on market best practice which focused on risk management but also questions of executive pay and the role of credit rating agencies.

Policy responses intensified from September 2008 and framed in explicitly systemic terms. Bail-outs and take-overs were orchestrated (notably part-nationalization of the insurer AIG, nationalization of agencies Fannie Mae and Freddie Mac, and the take-over of Merrill Lynch by Bank of America and of HBOS by Lloyds TSB), with the significant exception of the case of Lehman Brothers which underlined that teaching market discipline amid a crisis can pose its own challenges. Cross-border cooperation was shown to work, as demonstrated in the instances of Fortis and Dexia and the involvement of Benelux and French authorities, or fail, as revealed by British and Icelandic disagreements in the aftermath of the near-failure and subsequent nationalization of Landsbanki. The business model of investment banking was also put into question, with Morgan Stanley and Goldman Sachs becoming commercial banks, while some central banks provided guarantees for interbank lending. On the policy side, specific rescue plans were put in place, both in the U.S. and Europe as authorities struggled to restore confidence in the system, in terms of ensuring liquidity, safeguarding large institutions and insuring deposits. At the same time, discussions of the effects of the crisis on the real economy became more central to analyses as the use of taxpayer funds needed to be explained and justified, and the global economic downturn called for renewed attention to the links between financial stability and monetary policy. In this context, responses to the crisis have mostly been an affair of individual states and a reminder of the fiscal, and thus national dimension of financial stability.

At the global level, the focus became one of coordination and a (re)discovery of the institutions and fora available for managing the crisis and debating reform of the system. High expectations were attached to the activities of the G-20, a group bringing together large advanced and emerging economies and both the role of the International Monetary Fund (IMF), the now renamed and expanded Financial Stability Board (FSB - formerly FSF) were reassessed, while standard-setting bodies such as the Basel Committee and the International Organization of Securities Commissions (IOSCO) expanded their memberships and produced guidance on technical issues. Elsewhere, the process of discovery or rediscovery has led to increased membership and renewed interest in the International Association of Deposit Insurers, and a reliance on Export-Import banks and

other such ‘anachronisms’. These financial architecture questions are far from settled and will likely dominate discussions in the months ahead.⁴

At the same time, a plethora of initiatives and reports have been produced, assessing the causes of the crisis and offering recommendations for reform. These have included the aforementioned FSF report on broad standards and the IIF report covering market practices, but also reports by the Counterparty Risk Management Policy Group (a private sector initiative on market practices and systemic risk), the Group of Thirty (an independent report on financial stability), the Geneva Report (a technical expert report on financial regulation), the report of the High Level Group on Financial Supervision in the European Union (EU) (known as the De Larosière report and focusing on consolidating and rationalizing supervision in the EU) and the Turner Review (produced under the auspices of the U.K. Financial Services Authority). To these assessments and recommendations have been added several formal pronouncements, especially in the context of the G20, as well as guidance documentation by established standard-setting bodies. Table 1 (annex to this paper) provides a brief overview of the key areas covered by the reform recommendations in play and the focus of principal Basel Committee and IOSCO guidance and proposals for consultation.

So what have been the main aspects of the response and reform proposals? At the global level, the trend has been towards inclusiveness, coordination and the maintenance of an informal Basel-based regulatory standard-producing institutional framework. But these changes can be seen as of a ‘millimetric’ nature: existing institutions and fora have been given more to do but little in a formal sense that is concrete, regulatory or binding. Despite a renewed interest in the IMF and the credible research of the Bank for International Settlements (BIS), key gaps such as an early warning system and the authority to get participants to listen to those warnings have not been addressed. On the other hand, the role of states has been reaffirmed, and their functions reassessed, with a re-nationalization and re-politicization of finance policy in light of the use of tax payer funds in bail-outs and rescue plans. The financial sector has been shown to have special status, both in its command of rescue funds and in the flexibility or suspension of principles related to competition policy in the context of crisis management. These considerations are especially manifest in the case of the EU, where both the rhetoric and the policy responses have exhibited a certain degree of schizophrenia, straddling the consolidation versus fragmentation debate, ranging from beggar-thy-neighbour reactions to deposit insurance to serious debates about a more consolidated, pan-European and fully integrated financial sector.

On the content of regulation, reform proposals have focused on elements seen as key to the crisis: addressing the weaknesses and missing elements in risk management, introducing counter-cyclicality measures and establishing improved systemic oversight with macro-prudential regulation. The Basel Committee, for example, has concentrated its efforts on the production of guidance for better coverage of banks' risk exposures, including for securitization, and derivative activities; the inclusion of countercyclical capital buffers; the introduction of non-risk based measures to complement the provisions of Basel II; the building of stronger governance standards and increased transparency;

and the addition of measures for systemic macroprudential supervision. Further measures of the now expanded committee have focused on stress testing, deposit insurance and enhancements to the Basel II standards (Basel Committee 2009a and 2009b). Some of these regulatory changes represent a significant shift in practice; regulation as risk management was a key feature of the system which, regardless of the models' weaknesses, focused on return: "enthusiasm about return gave way to hubris and a collective blind eye was turned to the resulting risk" (Haldane 2009a: 5), with risk management used to manage regulation as much as risk. This has been especially highlighted in the case of over-the-counter derivatives, where proposals to document trades in central counterparties and thus map counterparties across the system are seen as measures which will "enable the government to comprehensively regulate the OTC derivatives market for the first time" (Geithner 2009). The reform proposals also invariably identify weak links at the periphery of the crisis, including the role of credit rating agencies, regulation of hedge funds and a crackdown on tax havens, seen as long-term structural threats to the system by some, or popular noise by others. On the other hand, what reform proposals have thus far failed to do is to address financial innovation at the boundaries of regulation or the proliferation of similar risk management tools and herd behavior; at the same time, recommendations appear to assume that it is possible to regulate away systemic risk, despite the lack of concrete plans for dealing with large financial conglomerates that are commonly assumed to be too-big-to-fail.⁵

And what of the key features of the pre-crisis governance framework? How have these been affected? On the question of regulation, a clear shift towards less permissive and more pro-active regulation is taking place as the central tenet of self-regulation and self-supervision (risk management) has been discredited. Discourse and policy have also taken a somewhat adversarial turn when dealing with private sector influence (as exemplified by public debates on remuneration and incentive structures), though ideas emanating from private groups have been sought after. Financial policy has ostensibly been politicized and the links of the financial sector to the (global) real economy have been highlighted, both at the sources of the crisis and beyond. Finally, transnational standard setting through semi-formal and informal governance networks is being maintained but broadened to include new members. Is the governance of global financial activity about to change? And what role, if any, for the transnational policy community?

The limits of politicization in financial policy⁶

The evidence so far suggests that governments can be justifiably serious about financial reform. The crisis has, in several ways, re-politicized finance, putting it at the core of political discourse and rhetoric and at the forefront of media attention. The crisis has shown that, regardless of the global scope of financial activity, it falls on national taxpayers to fund financial rescues and funerals, thus highlighting the distributional consequences of finance (in bad times and good), challenging the notion that financial regulation issues might have limited distributional effects and opening avenues of contestation.⁷ Indeed, the fiscal responsibilities are costly not only in terms of volume of funding but have also led to the questioning of the ability of small and larger sovereigns alike to meet their financial obligations.⁸ The crisis also helped identify the links between

finance and the real economy, with effects going beyond the core countries at the source of financial instability. States beyond this core may be further affected as ironically, financial as well as labour markets in areas at the origin of the crisis are likely to recover faster. This calls for a debate on the purpose of finance as a wealth enabling or wealth producing part of the economy or, more narrowly, as a mechanism of allocation. In the midst of crisis management activity, discussions touched on whether finance should be more national, or whether there should be a stricter separation between utility and ‘casino’ aspects. These discussions, however, were on the whole not mirrored in report recommendations, nor reflected in the blueprints for reform produced by governments and regulatory authorities.

Despite an initial willingness to ‘act’, states may indeed be constrained by the politics of reform. It is now widely acknowledged that both the financial system and monetary policy have been used for social policy purposes, and as a means for many Anglophone economies to widen opportunities in the provision of credit (Seabrooke 2006). The financial system has facilitated the provision of credit and the ownership of assets, meeting widespread public expectations of home ownership in such economies. This state of affairs has been promoted as a social good, leading to investment and smoothing of consumption. In the run-up to the credit crisis, the system overshot. In this sense, some states have been voluntary (and active) participants in the securitization processes that are a key feature of the 2007-2008 crisis. The merits of such policies have been widely debated⁹ but it is widely acknowledged that the practices (and accompanying securitization) will prevail in post-crisis finance. There are clear trade offs involved in this provision of opportunity for all and financial stability may be sacrificed.

States may also be held back in the pursuit of reform by the role of finance as a growth strategy. Some reform proposals are likely to generate unease as the crisis becomes less acute if they are seen to threaten the position of dominant financial markets: “the race between London and New York is not dead – just suspended for a time”.¹⁰ Similarly, having exposed the weaknesses of cross-border arrangements, the crisis pressed European Union leaders to re-consider regional supervisory responsibilities. The aforementioned De Larosière report advocates a series of steps to this end, including coordination on systemic issues through the European Systemic Risk Council (under the aegis of the European Central Bank) and the establishment of ‘colleges of supervisors’. These measures would bring much needed coordination and consistency in the oversight of large European financial institutions and would be seen as a welcome development by the private sector. The crisis has provided an opportunity for consolidated supervision of cross-border institutions within the Eurozone in particular and an end to the contradictions arising from a single currency and cross-border banking system on the one hand and a fragmented supervisory environment on the other. Early Europe-wide consensus was indeed enshrined in the De Larosière report but this consensus is now seen to be weakening. Some fear the re-emergence of old style European politics with the United Kingdom trying to get out and break this consensus on the basis of competitiveness concerns and the perceived importance of the City of London.¹¹ This could lead to an uncomfortable compromise of continuing financial integration against a background of weak formal structures and informal coordination network mechanisms. It

would also severely limit the ability of the EU to provide an alternative coherent regulatory framework for financial activity.

Finally, states may be constrained by the competence and capacity of public institutions to effectively deal with crisis management and prepare for the aftermath. At the moment, no one seems to be thinking about how the state and governments in particular ‘get out’ of the business of running finance. The lack of preparation of potential exit strategies creates a principal-agent problem where short term solutions have been advocated to deal with long term problems, exacerbating the burden on the fiscal system. Elsewhere, governments have discovered that they are unable to exit because the financial institution they are propping up is significant in a particular context (witness the regional position of Northern Rock in the United Kingdom) and have been worrying about the competition issues raised by their involvement in parts of the financial system. More broadly, exit strategies with respect to monetary policy also remain under-explored. This can be expected to provide the technocrats with room for manoeuvre in shaping reformed financial practice.

The above considerations suggest that there is a plethora of significant constraints at the domestic level that affect the reform opportunities linked to the re-politicization of finance. Governments face ephemeral or competing pressures in pursuing financial reform in response to the credit crisis. In that sense, explanations of regulatory change based on domestic politics provide the background against which reform proposals are negotiated but offer limited insight on the content of reform recommendations or the emerging global governance arrangements.

Great expectations and the politics of financial reform

A close examination of the emerging regulatory landscape further suggests that reform ambitions may indeed be somewhat modest. Despite some admissions of *mea culpa*, there has been little self-reflection in the regulatory and supervisory communities about their own failings and limitations. “Sometimes Adam Smith needs some help” was the possibly underwhelming assessment of one regulator regarding the future role of public agencies (Lemieux 2008). At the same time, the focus on ‘bankers’ and their practices has been one of popular blame culture with rituals of public humiliation¹² regarding practices and compensation, with bonus questions an especially strong distraction.¹³ The resulting public expectations on the role of the banking industry are unlikely to be met.

The reform proposals themselves also indicate that statements on the general principles of a reformed financial system are translated into a technical tweaking of the system. The more significant regulatory adjustments are facing obstacles in their implementation as the traditional agency turf wars in the United States and beyond are likely to hinder progress; indeed, resistance to some proposals may come not from the industry but the regulators themselves (The Economist 2009c). That is not to say that private actors are otherwise ready to be regulated but rather, that negotiations on the appropriate balance between rules and principles, transparency and competition, and innovation and stability

will be affected by public policy priorities, private sector preferences *and* the evolving institutional regulatory framework (domestic and global) itself, especially as currently parallel initiatives come to be interlinked and more clarity emerges as to which institutional settings might prevail.

A broader question, however, is one that goes to the core of the place of finance itself. The contract between finance and the state(s) has been one whose terms have been implicit but generous:

There was absolutely no incentive for individuals or teams to run severe stress tests and show these to management. First, because if there were such a severe shock, they would very likely lose their bonus and possibly their jobs. Second, because in that event the authorities would have to step-in anyway to save a bank and others suffering a similar plight.¹⁴

Heads we win, tails the government picks up the pieces.¹⁵

Investment banking is the last Marxist business, with profits going to employees.¹⁶

The implicit terms of the contract between finance and the state have been generous indeed. Financial conglomerates have been allowed lower capital buffers by the markets (and eventually by Basel 2) because of an implicit guarantee of government assistance or bail-out. And in a time of crisis, as the example of Lehmann Brothers have indicated, moral hazard concerns may be overlooked as “when failures are systemic, the danger is that one will end up with a morally disciplined but totally devastated economy” (Goodhart - CSFI 2009: 35). This is unlikely to change and if anything, crisis management has led to ever larger financial institutions and thus greater moral hazard. “Size matters. Historically, the safety net was perceived to be fur-lined for those of a certain size” (Haldane 2009b: 27) and an ever more concentrated banking system means that even fewer institutions will in the future be small enough so that they are allowed to fail or even unwound in an orderly manner. This is an issue on which most current reform proposals are timid or silent.¹⁷ States have put themselves in a position where their authority and credibility are seriously challenged and yet hindering the development of too big to fail financial institutions is not seen as realistic.¹⁸

This generous and asymmetric contract is sustained by a nineteenth century conception of the state and the pursuit of the public interest which does not correspond to economic space and key public policy functions today. Public action continues to focus more on building financial stability than ensuring long-term linkages between financial stability as understood by finance practitioners and other national (or regional) economic priorities. The contract may yet be affected by a reorganization of stakeholders of financial policy along the lines of what Mattli and Woods (2009) suggest could lead to “common interest regulation”. In this framework, reform proposals would be discussed and negotiated in a more inclusive, non-technical and transparent manner while certain additional conditions would also be met: information would be available so that stakeholders are better educated about their interests and those of others, policy entrepreneurs (from the public

and the private sector) would enact discussions on change, and new economic ideas would be used to explain, justify and legitimize new forms of regulation.

Empirically, this would require for the experts who have so spectacularly failed in the run-up to the crisis to move on from public and private boards and for a refocused attention on fiduciary responsibility to take hold; for more clarity, on the part of policy-makers, with respect to social and business solutions to the crisis; for new ideas, which might already exist in other areas or fields of study, to be applied to thinking about financial reform; to broader programmes of financial information dissemination and improved education in finance and money; and for more activism in public companies.¹⁹ The following section offers some explanations on why these conditions are not being met in discussions for reform in this current crisis.

Transnationalism revisited: the resilience of informal network governance

The nature of the reform recommendations in play is such that proposals are not exhibiting much that is ‘new’ or meaningfully inclusive. Reports have been produced by members of the same transnational policy community of actors responsible for the pre-crisis governance arrangements. Members of the community, in their various capacities, have served as key individuals in the unfolding of the crisis and its aftermath. Is it a case of the community closing ranks? A clear-cut case of technical expertise? Or a lack of imagination on where alternative ideas may be found? In fact, their continuing roles shows the extent to which the transnational policy community has claimed (and convinced of) exclusive expertise of the issues at hand, and that in light of strong public outcry.

So why are authorities not more independent from this community and its constituent members? “In a fight, the regulators have the legal power. But the financiers have the political power, at least when there is no financial crisis in progress” (Economist 2009a: 18). So the answer may partly lie in what made them less than ideally independent over the past thirty years. In the first place, it is a question of expertise. It has been amply documented that as finance became more complex, it became more difficult for public officials to keep up and compensation structures contributed to a shortage of competency in the official sector. The relationship between the regulators and the regulated is thus an unavoidable one. The only way for a regulator to know what needs to be regulated is to find out from market participants and hence, proximity to the market is valuable. Moreover, there has been agreement in the past that regulators should stay one step behind the market so as not to create market distortions, nor hinder financial innovation. The trick has been to get the ‘only one’ step behind part right.²⁰

The question remains, however, that there were no fights about power – which suggests that the adversarial nature of some crisis exchanges is not an instance of a process that is deeply confrontational. The revival of market ideas in the past thirty years was accompanied by an aura of respect and an intellectual inclination to recognize the superiority of these ideas. In parallel, the sociological phenomenon of compensation in the private sector may have reduced, among public officials, the sense that they were

pursuing a superior good.²¹ Another aspect, often overlooked, is that for a generation of regulators and supervisors, the key battle was to make public agencies independent of politics. Their aim was to avoid political influence as well as short-term electioneering and political interference in the mechanisms of markets. Over the past thirty years, this led to a situation of capture, essentially of an intellectual kind, whereby economic ideas about what constituted appropriate financial regulation came to mirror private sector preferences and confirm suspicions of political meddling. In turn, it also determined the institutional parameters of financial governance, contributing to a move to a transnational technocratic governance framework, where such intellectual capture is more likely to take hold.

In the aftermath of the crisis, some of the glamour of the private sector may have faded and the official sector might suffer less of an inferiority complex but the two sides are still in this together and informal governance networks such as the Basel Committee or the FSB remain, strengthened. Among the practitioners of finance, the suspicion of government priorities in the running of finance remains and doubts are cast on governments' ability to be in charge of banks or adopt a longer term perspective in the shaping of financial regulation. As a result of both this mistrust of politics and the need for expertise, the 'grand old men' of finance and their connections have been a central feature of the responses to the crisis. The private sector, as represented by the IIF has been savvy, ahead of the curve with recommendations, shaping the debate in terms of what private institutions think went wrong and how their behaviour should change, and in turn pushing other aspects off the agenda.²² By positioning themselves early (indeed, many of the early reform recommendations originated in the private sector), private actors set the agenda and attributed much blame on non-banking issues (such as mortgage brokers and credit rating agencies), exhibiting coherence and defending the interests of banking institutions, all the while safeguarding the risk management principles of regulation and suggesting tweaking solutions. The process displays characteristics of traditional lobbying but also, relies on the long legitimized policy space and functions held by private actors in the context of the transnational policy community. The phenomenon of revolving doors further reinforces both the familiarity and shared understandings about the crisis and the options for reform – and raises a more practical question of capture, whereby when regulators are aware that they yet may move to become the regulated, they might be more attuned to the need for market-friendly regulatory standards.

As a result, we can see that reform efforts cannot be about the formal structure of governance arrangements alone (such as the membership of committees and institutions) but would need to address the informal governance networks through which privileged access to the policy process actually takes place. At the same time, how we understand the role of the private sector cannot rely on an account of the material interests of firms alone; private preferences for particular policies and governance arrangements also relate to the process of financial governance itself. This also explains why we need to break with the habit of equating market-friendly policies with understandings of neoliberal economic orthodoxy; a look at the content of financial policy and its reform amply indicates that market mechanisms alone are not in operation but rather, that policies serve

the interests of the members of the policy community in ways not directly advocated by economic theory.

Conclusions

In light of the above analysis, let me finally offer some explicit answers to some key questions at this stage of international regulatory reform and change. On the whole, the global credit crisis can be seen to have led to an expansion of the perimeters of international regulation, the strengthening of the institutional architecture and a halt to the practice of delegation of authority to the private sector as key features of the emerging regulatory landscape. The analysis in this paper confirms the first two as broad trends but reserves judgment on the third issue; the resilience of the transnational policy community in a time of acute crisis implies that in some cases, authority is not just delegated from the public to the private but may actually be ‘lost’ as institutional arrangements evolve and policy-making functions are legitimized over time. In this context, the regulatory changes observed take place primarily against a strong transnational governance background, one of informal network governance by an expert policy community of regulators, supervisors and private actors; the sociology of the community, that is its strong intellectual and practical connections ensure its resilience and are likely to preserve a policy role for the private sector.

In turn, this leads me to suggest that though regulatory reforms are underway, the changes advocated are limited and thus do not constitute a significant turning point in financial regulation. The system is being tweaked rather than reformed. In this instance, governance arrangements prior to the crisis are affecting the aftermath; the role of expertise and the institutional robustness of the informal governance networks have limited the supply of reform ideas and defined what is possible in terms of reform recommendations and policy implementation. The crisis has threatened the coherence of the transnational policy community, but the coziness of the community and the enduring allure of expertise have kept its members at the centre of reform debates. So while some important regulatory shifts are taking place, the intellectual and institutional parameters of international regulatory change are being defined by the protagonists of the pre-crisis governance arrangements and the key terms of the implicit and generous contract between finance and the state remain intact.

Annex 1: Reform recommendations in play – key areas addressed

	Risk Management	Capital Requirements	Remuneration	Transparency	Systemic Institutions	Non-banks	OTC central counterparties	Ratings	Accounting	Monetary Policy	International Coordination
IIF	√	√	√	√		√		√			√
CRMPG	√	√			√	√			√	√	
G30	√	√	√	√	√	√		√			√
Geneva	√	√			√						√
FSF	√	√	√	√	√	√		√	√		√
Basel Committee	√	√		√	√						√
IOSCO	√			√	√	√	√	√			√
De Larosière	√	√	√		√	√	√	√	√		√
Turner	√	√	√		√	√	√	√			√

Endnotes

¹ The Group of Thirty (G30) provides an indicative overview of the type of individual and expertise at the heart of this community, bringing together central bankers, directors of international financial institutions, senior executives of large financial institutions and leading economists, most of whom have moved extensively through the ‘revolving doors’. For more information on the G30 and its membership, see www.group30.org.

² The development of the Basel Committee as an influential actor in global financial governance has been well documented (Kapstein 1991 and Wood 2005). Other work has also focused on state preferences for standard setting bodies such as the Basel Committee in questions of banking regulation (Drezner 2007) or explored diffusion mechanisms in the production of international agreements and standards as linked to understandings of the self-interest of states (Simmons et al. 2008). Elsewhere, the literature has explored the activities of the Basel Committee in terms of network governance (Marcussen 2007). This paper understands the Basel Committee as part of a broader transnational policy community, allowing for an improved understanding of the influence of private interests and priorities in the policy process. For an analysis of the role of this community in the making of Basel 2, see Tsingou (2010).

³ For a sobering analysis of missed warning and policy opportunities, see the Bank for International Settlements (BIS) Annual Report (2009).

⁴ The G20 was originally comprised of the finance ministers and central bank governors of Argentina, Australia, Brazil, Canada, China, France, Germany, India, Indonesia, Italy, Japan, Mexico, Russia, Saudi Arabia, South Africa, South Korea, Turkey, United Kingdom, the United States and the European Union. Meetings are also attended by top management of the international financial institutions. In autumn 2008, the G20 concept was expanded to include leader meetings. The FSB is comprised of the original FSF members, that is the national financial authorities of G7 countries, Australia, Hong Kong, the Netherlands, Singapore and Switzerland, as well as international financial institutions, international regulatory and supervisory groups, committees of central bank experts and the European Central Bank; in addition, the FSB includes new members of the G20 countries not originally in the FSF, that is Argentina, Brazil, China, India, Indonesia, Korea, Mexico, Russia, Saudi Arabia, South Africa and Turkey. The Basel Committee is now comprised of representatives from Argentina, Australia, Belgium, Brazil, Canada, China, France, Germany, Hong Kong, India, Indonesia, Italy, Japan, Korea, Luxembourg, Mexico, the Netherlands, Russia, Saudi Arabia, Singapore, South Africa, Spain, Sweden, Switzerland, Turkey, the United Kingdom and the United States. IOSCO’s Technical committee was also expanded to include Brazil, China and India, as well as existing members Australia, Canada, France, Germany, Hong Kong, Italy, Japan, Mexico, the Netherlands, Spain, Switzerland, the United Kingdom and the United States.

⁵ The jury is still out on the significance of too-big-to-fail. The crisis has shown that systemically important institutions are not determined by size alone, though there are increasing calls warning about the size of a newly consolidated financial sector, especially in the US, where both the head of the Federal Deposit Insurance Corporation and the President of the Federal Reserve Bank of Boston have highlighted the challenges of systemically significant institutions. On the other hand, in the European Union the debate is less likely to be framed in terms of size as practitioners in the official and private sectors alike are keen to consolidate cross-border, pan-European conglomerates in practice (interview with European Central Bank official, June 2009).

⁶ This section and the next have been informed by research interviews in November 2008 and May-June 2009 with current and former public sector officials, private sector practitioners, and a selection of ‘wise men’. The majority of interview subjects are resident in Europe (Belgium, France, Germany, Italy and UK) but some evidence is also taken from interviews with US-based individuals.

⁷ For an account of the lack of distributional conflict in financial regulation see Kahler and Lake (2009).

⁸ Witness the situation of Iceland and much of Central and Eastern Europe. Other examples include S&P's questioning of the United Kingdom's ability to meet its financial obligations in May 2009 or the case of the European Investment Bank, which has been able to raise funds in capital markets with much more favourable terms than many of the EU's member states.

⁹ Interviews suggest that this is a polarizing issue, among Europeans in particular. There is, however, growing unease about engaging with this type of social policy outside the domain of taxation in Anglophone economies as well, as interviews with regulators in the United Kingdom have indicated (May 2009).

¹⁰ Remark made by Gerd Häusler, Director of the Board, RHJ International SA at the 2nd Transatlantic Dialogue on 'International Financial Governance – Shaping the Future of the Global Economy, BMW Stiftung Herbert Quandt, Berlin, 26-27 March 2009.

¹¹ Observation based on an interview with a Central Bank Governor of the Eurozone (June 2009). These disagreements may be more vocal in public political terms than they are in the practice of regulatory reform as advocated by the European Commission (see also Elliot Posner in this volume).

¹² Note, in particular, the discourse in the media, as well as the tone of the conversations in hearings in the US Congress or the UK Treasury Select Committee.

¹³ Interestingly, the discussions on bonuses and incentive structures for private sector employees originated in the private sector in the first phase of the crisis and emerged as an industry idea in the IIF pre-report in March 2008 – according to the Managing Director of the IIF, this was a controversial enough move at the time for one prominent IIF member to temporarily withdraw from the institute (Goldman Sachs).

¹⁴ Banker's admission at a Bank of England stress-testing seminar ahead of the crisis (Haldane 2009a: 12).

¹⁵ As stated by Robert Monks (CSGI 2009: 55).

¹⁶ As stated by Gerd Häusler (see footnote 6).

¹⁷ In fact, proposals remain in the realm of academia; see, for example, Raghuram Rajan's proposals (as outlined in the Economist 2009b: 78).

¹⁸ Indeed interview evidence suggests that the issue is too politically controversial to address (interviews with Bank of England officials, May 2009).

¹⁹ Interviews with practitioners suggest that this would be a useful but currently unrealistic scenario; the necessary setting for a more pluralistic stakeholder approach to regulation was primarily discussed with non-bank market participants in interviews in May 2009, who focused extensively on the importance of financial education.

²⁰ These ideas have been elaborated in Davies and Green (2008).

²¹ This point was particularly stressed in an interview with Tommaso Padoa-Schioppa (November 2008).

²² In the words of a public sector official, the IIF has actually had "a good war" (confidential interview, May 2009).

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Regulators have responded to the crisis by reforming the global prudential framework and enhancing supervision. The key goals of these reforms have been to increase banks' resilience through stronger capital and liquidity buffers, and reduce implicit public subsidies and the impact of bank failures on the economy and taxpayers through enhanced recovery and resolution regimes. The increased use of stress testing by banks and supervisors since the crisis also provides for greater resilience on a forward-looking basis, which should help support credit flows in good and bad times. Crisis-era losses combined with regulatory changes have motivated a significant reduction in risk and scale in the non-equity trading and market-making businesses of a number of global banks. Keywords: Financial crises, regulation, systemic risks, macroprudential policies. Credit booms are often associated with deterioration in lending standards "as observed in the subprime lending in the United States. While booms do not always cause crises, they do make them more likely (Dell'Ariccia, et al., 2012) and most financial crises are in some way related to credit extension to borrowers that become non-performing. Moreover, credit booms are typically associated with high leverage, which is why they can be so dangerous. Policy-makers have sought to rectify the damage done to financial systems and economies by enacting a large set of financial reforms, both at the international and domestic level. Request PDF | On Jan 1, 2010, Eleni Tsingou and others published Regulatory Reactions to the Global Credit Crisis: Analysing a Policy Community Under Stress | Find, read and cite all the research you need on ResearchGate. This argument will be explored through a comparative study of the impact of transnational pressures on policy-makers in Europe and the US in the immediate aftermath of the crisis. In the conclusion, the article shortly discusses the substance of the financial reforms that have been undertaken. View.