The Political Economy of Financial Regulation

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“[Basel] brought forth a mouse”

- Post 2007: a consensus for a new approach to capital regulation to safeguard the future stability of the international banking system
- Feb. 2009 (de Larosiere Report): demand for a “fundamental review” of Basel II on the grounds that it “underestimated some important risks and over-estimated banks’ ability to handle them”
- Dec. 2009: BCBS put forward concrete proposals on Basel III

Basel: the mouse that did not roar

The new banking rules are simply insufficient

MARTIN WOLF + Add to myFT

By **Martin Wolf** SEPTEMBER 14 2010

To celebrate the second anniversary of the fall of Lehman, the mountain of Basel has laboured mightily and brought forth a mouse. Needless to say, the banking industry will insist the mouse is a tiger about to gobble up the world economy. Such special pleading – of which this pampered industry is a master – should be ignored: withdrawing incentives for reckless behaviour is not a cost to society; it is costly to the beneficiaries. The latter must not be confused with the former. The world needs a smaller and safer banking industry. The defect of the new rules is that they will fail to deliver this.

Am I being too harsh? “Global banking regulators ...sealed a deal to ...triple the size of the capital reserves that the world’s banks must hold against losses,” says the FT. This sounds tough, but only if one fails to realise that tripling almost nothing does not give one very much.

The new package sets a risk-weighted capital ratio of 4.5 per cent, more than double the current 2 per cent level, plus a new buffer of 2.5 per cent. Banks whose capital falls within the buffer zone will face restrictions on paying dividends and discretionary bonuses. So the rule sets an effective floor of 7 per cent. But the new standards are also to be implemented fully by 2019, by when the world will probably have seen another financial crisis or two.

What this paper does

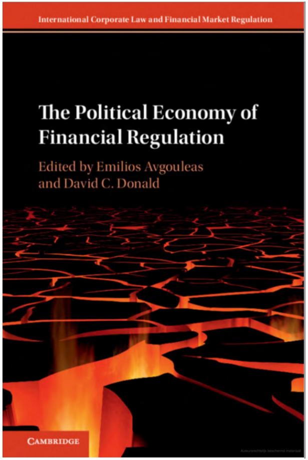
- Examines opposition to or watering down of issues from Basel Accords
- Classifies positions of regulators and banks using data from multiple sources (text analysis of speeches + leaks → excellent!)
- Finds that
  - The probability of the national regulator of opposing a proposal increases if it is opposed by national champions, and even more so the higher their comparative disadvantage
  - Regulators with prior experience in large banks drive the effect
  - Disagreement across regulators leads to the watering down of the original proposal
- Concludes that national interests (being either political or economic) hinders the harmonization of international banking standards

Contribution

- One of few papers on the political economy of international banking regulation
  - Kroszner and Strahan (1998 [5]): relative strength of winners and losers and bank branching deregulation in the US
  - Igan and Mishra (2014 [4]) and Ban and You (2019 [2]): interest group lobbying and US financial regulation
  - Mishra and Reshef (2019 [7]): central bankers' finance experience and financial deregulation around the world
  - Aktas et al. (2007 [1]) and Dinc and Erel (2013 [8]): national champions and M&A regulations in the EU
  - IPE/PolSci/Law literature (Singer 2004 [9]; Wood 2005 [10]; Lall 2012 [6]; Young 2012 [11]; Howarth and Quaglia 2016 [3]): the politics of Basel Accords
- Econometric analysis of political-economic considerations of regulators in the international/Basel rulemaking process is novel

Comment 0. Change the title: "déjà vu"

- "The Political Economy of International Banking Regulation"
- "The Political Economy of Basel Accords"
- "The International Political Economy of Basel Accords"



Key stages of the (opaque) Basel regulatory process

Suggestion 1. What happens before the initial-proposal stage matters

- Large international banks have privileged access to the Basel process from a very early stage (prior to the consultation)
- Large international banks (mainly via Institute of International Finance, IIF) are the first movers in the regulatory process $\Rightarrow$ latecomers (i.e. general public, smaller banks) are disadvantaged
- National champions always oppose regulation (36$\times$)

Questions:

- Why assuming that initial proposal designed by working groups Pareto-improving in welfare?
- To what extent do discussions (and influence) to arrive at the initial proposal bias estimates? Bias can go in both directions

(Reverse) revolving door

- Prior being a BCBS member, NY Fed's Marc Saidenberg, was Head of Regulatory Policy at Merrill Lynch and a member of the IIF Committee until 2008
- During the Basel III negotiations, Roger Ferguson (Fed Board), Darryll Hendricks (NY Fed), and Patricia Jackson (BoE) either sat on the IIF's board or chaired IIF's working groups
- During these negotiations, the IIF even managed to recruit Jacques de Larosiere (author of the report and former governor of BdF)

"Capital ratios [...] could substantially harm our economies. I see a great danger here. Regulators must not start piling new ratios on the existing ones, adding further requirements (leverage ratios, special ratios on large systemically important institutions, anti-cyclical capital buffers) to the normal [...] Basel 2 risk-based system. [...] Together, their impact could be lethal." (Financial Times, Oct. 2009)

First-mover advantage

- BNP Paribas: the reforms would result in "either two guaranteed years of deep recession or four years of zero growth" for Europe (Apr. 2010)
- IIF: a 2% increase in overall capital requirements would cut cumulative economic output by 3.1% in the Eurozone, the US and Japan by 2015, wiping out more than nine million jobs in the process (Jun. 2010)
- Quantitative Impact Study (by BCBS and FSB): a 2% rise would reduce output by a mere 0.38% over five years (Aug. 2010)
- Regulators decided against significantly higher requirements (Sep. 2010)
- $\Rightarrow$ Latecomers lack institutional knowledge, technical capacity, financial resources, and time to influence outcomes
- $\Rightarrow$ Each stage is not static

Suggestion 2. How the negotiation stage happens matters

Negotiation remains a black-box (despite the large literature) $\Rightarrow$ understanding the nature of influence is key to improve regulatory process and regulation

Go beyond simple (reverse) revolving-door arguments: How (mechanism)?

- Direct pressures?
- Conformity?
- Career concerns?
- Bribery?
- Force of persuasion using arguments and evidence (lobbying)?
- Identity (in-group effect)?
- Status?
- Relationships (social networks)?

Suggestion 3. What shapes regulator/bank interests matters

Diverging interests between large banks $\Rightarrow$ understanding the source of disagreement is also key to inform regulatory process and regulation

What are the economic interests fundamentally shaping national regulators' position when a disagreement is observed?

- Bank capital position
- Bank-based financial system
- Global competition

Further understanding of the actual international political economy of Basel Accords

- There is surprisingly little about the opposition vs. alignment between countries/regulators on issues from Basel II and III
- Is the effect stronger for Basel II?

Suggestion 4. Bank (and regulator) heterogeneity matters

- The identity and motivations of national champions are unclear (no summary statistics for key variables)
  - Is assuming one champion per country reasonable? Are "small banks" small?
  - Can a national champion change over time?
  - Large international banks also rely on association (most notably, the IIF)
  - Who is the champion in the EU? Are France, Germany and UK part of the EU here?
  - Can a champion be champion in several countries (e.g. champion in both France and EU)?
- Similar remarks apply for regulators
- National champions vs. large international banks

My take

- Fascinating and super important topic
- Ingenious use of multiple data sources
- Highly recommended paper
- My suggestions:
    - More international political economy insights
    - More on "selection" of initial proposals
    - More on mechanisms of influence/capture
    - More on bank heterogeneity (measurement)
    - Clarification of contribution w.r.t other scholarly disciplines
- Good luck!

Thank You!

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