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## Harnessing Global Finance

– Is there divergence in global banking regulation?

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Is there divergence in global banking regulation?

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## Abstract

Convergence theory has dominated the discussion of global financial governance. The perspective argues that the confrontation between the global market and state institutions leads to policy convergence. However, rather than accept this conclusion, this study has examined banking regulation in four countries, the United States, Canada, Britain, and Germany to test whether they converge. By comparing how these countries regulate banking in terms of policy interests, the study finds that there is indeed divergence between them in contrast to what convergence theory would predict.

## **Preface**

This thesis marks the end of a two-year program at the Norwegian University for Science and Technology. I would therefore like to take the opportunity to extend my gratitude to my supervisor, Jonathon Moses of the Department of Sociology and Political Science, for expertly guiding my process. I would also like to thank my wife, Emily Thuswaldner, for putting her career aside and accompanying me to Norway so that I could complete this degree.

Trondheim, 15.05.2012,

Peder Sørås

## Contents

<b>2. GLOBAL UPHEAVAL: CRISIS AND POWER SHIFTS</b>	<b>7</b>
<b>3. THEORETICAL CONCEPTS</b>	<b>9</b>
<b>3.2 THEORETICAL BACKGROUND</b>	<b>11</b>
3.2.1 THE STRUCTURAL APPROACH: CONVERGENCE THEORY	12
3.2.2 ADDRESSING THE ASSUMPTIONS	14
3.2.3 THE INTERNATIONAL REGULATORY COORDINATION MODEL	15
<b>4. CASES AND EXPECTATIONS</b>	<b>20</b>
<b>4.1 CASE SELECTION</b>	<b>20</b>
<b>4.2 EXPECTATIONS</b>	<b>22</b>
<b>5. DATA</b>	<b>24</b>
<b>5.1 BASEL</b>	<b>24</b>
5.1.1 CLUB NEGOTIATION	26
<b>5.2 COUNTRY CASES</b>	<b>30</b>
5.2.1 THE FINANCIAL CRISIS	31
5.2.2 THE BANKING SECTORS	37
5.2.3 MAIN REGULATORY BODIES AND LEGISLATION	44
5.2.4 REQUIREMENTS AND STANDARDS	52
5.2.5 FINDINGS	67
<b>6. ANALYSIS</b>	<b>67</b>
6.1.1 THE US	68
6.1.2 CANADA	70
6.1.3 THE EU	71
6.1.4 THE UK	72
6.1.5 GERMANY	73
<b>6.2 CONVERGENCE OR DIVERGENCE?</b>	<b>75</b>
6.2.1 GLOBALLY	75
6.2.2 NATIONAL DILUTION	77
<b>6.3 COMPETITION- DIVERGENCE?</b>	<b>84</b>
<b>7. CONCLUSION</b>	<b>86</b>
<b>7.1 IDEAS FOR FURTHER RESEARCH:</b>	<b>87</b>
<b>8. REFERENCES</b>	<b>88</b>

## 1. Introduction

In response to the Global Financial Crisis of 2007-08 there have been major attempts to restructure the regulation of banks. In the spirit of neoliberalism, it has been assumed that these attempts are driven by globalization in the form of competition between the market, (as an abstract constellation of decentralized individuals and firms)<sup>1</sup> and national institutions.<sup>2</sup> According to this perspective, globalization increases the number and power of actors in the market and consequently leads to policy convergence at the market's terms. To further contribute to the discussion of global financial regulation, this study aspires to investigate this claim. However, rather than accept the conclusions of neoliberal convergence theory, it aims to test the assumption that the confrontation between the global market and state institutions leads to policy convergence. This test, based on an empirical assessment of bank regulation in the United States, Canada, Britain, and Germany, indicates an increasing divergence in state regulation.

The scholarship on global financial regulation has been dominated by one filter of analysis, neoliberal convergence theory. The key to this theory lies in its reliance on the explanatory power of global market structures in shaping a single 'best practice' preference for policy amongst exposed states. It would be interesting then to note divergence between the ways that states govern finance. As this paper argues, one of the areas where this occurs is in bank regulation. Policies that govern banks depend on technical specifications where minor deviations can have significant impacts. Examining such policies in detail will enable us to assess the presence of divergence.

The study will aim at investigating this puzzle by observing national policies. It will examine these as dynamic state interests\* rather than assume they are the result of the structural forces of the global financial market, and in this way provide a new perspective on a contemporary issue. Innate and possibly diverging interests are not included as a factor in the convergence model, thus observing bank regulation in this perspective will make it possible to examine global trends in a more fulfilling way. Naturally, the key to rejecting market caused convergence lies in

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<sup>1</sup> Bruner, C. M., & Abdedal, R. (2005). To Judge Leviathan: Sovereign Credit Ratings, National Law, and the World Economy. *Journal of Public Policy*, 25 (2), pp. 191-217: 191

<sup>2</sup> Drezner, D. W. (2007). *All Politics is Global: Explaining International Regulatory Regimes*. Oxford, United Kingdom: Princeton University Press: preface

\* It should be noted that the aim is not to study path dependent interests in the way of variegated capitalism typically associated with Hall and Soskice (Hall, P. A., & Soskice, D. (Eds.). (2001). *Varieties of Capitalism- The Institutional Foundations of Comparative Advantage*. Oxford, UK: Oxford University Press.) but rather understanding policy interests as fluent and changeable.

assessing relevant policies, the area where the theory claims there will be decreased variance. By comparing different examples, it becomes clear that these policies have diverged despite the dominant assumption.

Other studies have argued for the presence of financial regulatory divergence before, however this study seeks to distance itself by first specifying on the particular topic of banking. As will be seen in chapter '2. Global upheaval: Crisis and power shifts' this topic is especially relevant to the contemporary regulatory reform. The Global Financial Crisis of 2007-08 (GFC) has in many ways reset the stage for financial regulation and increased the potency of examining global trends. In scrutinizing how countries have responded to the crisis, we get a fresh introduction to regulatory policy. This will be done by operationalizing and comparing the relevant regulatory policies of four different country examples; the United States, Canada, Britain, and Germany. The findings of this study suggest that there is an increasing divergence in the policies that regulate the activities of banks.

First, the background of financial crisis reform will be discussed in order to point out how the setting is optimal for this type of study. This explanation will underline how the results will be limited to indicating tendencies in possible permanent changes due to the temporal proximity of the financial crisis. Following, the discussion will conceptualize convergence as a measurable variable. This is easier said than done, considering the extensive previous literature on the subject. It is therefore natural to follow the discussion of the concept with a section considering this previous literature. Combined, these two sections will argue that the hypothesis should be assessed through an examination of national interests using a method of two-step analysis developed by Legro and Moravcsik.<sup>3</sup>

The two-step method lends itself to the study of country cases by examining and contrasting domestic political interests with international outcomes. As mentioned, this study will focus on four country examples, the United States, Canada, Germany and the United Kingdom. These will be presented and discussed in terms of their contribution within the theoretical framework. As will be explained in this section, it is pertinent to also understand international regulation through

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<sup>3</sup> Legro, J. W., & Moravcsik, A. (1999 Autumn). Is Anybody Still a Realist? *International Security*, 24 (2), pp. 5-55.

both the Basel Committee for Banking Supervision (BCBS) and the EU as part of fully appreciating international outcomes.

Section five will concern the empirical findings, subdivided into chapters on Basel negotiations, financial policy preferences and structures, policies, and policy methods and instruments based on the perspective prescribed in the theoretical outline. These findings will then be compared in the subsequent analysis section. This section will show how the empirical findings support expectations based on the theoretical framework that indicate a divergence in bank regulation between the four country cases. Firstly, the BCBS governance of banks has broken down and secondly, as this breakdown indicates; there are significant country differences in the aforementioned aspects of policy. Finally, the analysis will conclude by reiterating the study's main findings and presenting some possible new directions of study.

#### *Why does this matter?*

The analysis will add to the body of work on globalization. More specifically it will expand the discussion by challenging one of the assumptions behind it; that globalized markets lead to converging policies. The study will add to a contemporary development in the research frontier where this phenomenon is observed. Other recent analyses that question the neoliberal assumption have found that despite the increasing integration of the global economy, there is a growing freedom for states to act independently.<sup>4</sup> By focusing on the regulation of banks, this study is able to go into detail in capturing this growing political autonomy.

There are continual efforts between state leaders to meet at the global level to formalize regulatory standards. Arguably, markets rely on such rules and norms to function properly.<sup>5</sup> Therefore it is of great importance to analyze the influencing factors on these overarching agreements, be they formal or informal in nature. Analyzing the nuances of globalization, rather than accepting the concept as the abstract phenomenon it is often presented as, should add a tangible addition to a complete understanding of how global markets are regulated. Addressing

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<sup>4</sup> Helleiner, E., & Pagliari, S. (2011). The End of an Era in International Financial Regulation? A Postcrisis Research Agenda. *International Organization*, 65 (Winter), pp. 169-200; Hassel, A., & Lutz, S. (2010). Does the Financial Crisis Help to Overcome the Crisis of the State? (Durch die Krise aus der Krise. Die neue Stärke des Staates). *Der Moderne Staat Heft*, 3 (2), pp. 251-271; Drezner, D. W. (2007)

<sup>5</sup> Drezner (2007)

the GFC makes this particularly relevant in terms of understanding the political possibilities that follow a crisis.

## 2. Global upheaval: Crisis and power shifts

‘The global nature of the crisis provides analysts with particularly favourable conditions to advance this kind of comparative research agenda by exploring how this simultaneous shock has generated convergent or conflicting responses in different countries.’<sup>6</sup>

The subprime crisis revealed how large the extent of global financial integration has become. There have been other financial upheavals in recent times, but none have affected the overall trust in the global economic system to the same extent. The GFC has put demands on governments to respond to an ostensibly broken financial system. Because the crisis emerged from the financial sector, regulators are facing unprecedented scrutiny, most importantly from the general public.<sup>7</sup> If there were divergent discrepancies in the responses of similar states to these demands it would indicate that globalization does not force states to converge, but rather that other influencing factors must be addressed also.

Notably, the crisis most severely affected the states closest associated with promoting the Anglo-American financial regime. It will therefore be interesting to see whether this has had an effect on how global banking is regulated. Possibly, through delegitimizing the Anglo-American regime, the crisis has opened for the involvement of other actors.<sup>8</sup> According to Benne, Peck and Theodore, ‘many prominent commentators have claimed that the ideologies and practices of free-market capitalism, or neoliberalism, have been discredited, and that a new era of regulatory reform, based on aggressive state interventionism to restrain market forces, is dawning’.<sup>9</sup> This could possibly indicate a new consensus around which states will converge. However, rather than accept this as a new era of consensus, the study will evaluate the new reform to discover how states have responded to this impetus.

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<sup>6</sup> Helleiner and Pagliari (2011): 181.

<sup>7</sup> Holmquist, J. (2009). *Financial Services Roundtables: EU-US Cooperation in Financial Markets Regulation in Times of Crisis*. Washington DC: 3

<sup>8</sup> Helleiner, E. (2010). A Bretton Woods Moment? The 2007-2008 Crisis and the Future of Global Finance. *International Affairs*, 86 (3), pp. 619-636.

<sup>9</sup> Brenner, N., Peck, J., & Theodore, N. (2010). After Neoliberalization? *Globalizations*, 7 (3), pp. 327-345: 328



Others have looked at this puzzle before. For example, in their analysis of post crisis behaviour, Hassel and Lutz agree with Helleiner and Pagliari that states appear to be able to act decisively more independently than previously recognized.<sup>10</sup> This further confirms that despite economic integration, states can behave in distinctively divergent patterns. By exploring the proposed research question, this study will examine this puzzling evidence that contrasts the expectation that only global market power matters. This study will differ however, by examining one particular aspect of global finance that is especially relevant to both the topic and the crisis, namely banking.

Because the banking sector was at the centre of the GFC,<sup>11</sup> the following analysis will focus on the regulation of this sector as its centre of analysis. In their convincing study of financial crises, Reinhart and Rogoff emphasize the centrality of the banking sector in crisis events.<sup>12</sup> Indeed, the independence and subsequent regulatory capture by leading banks is by many respected commentators thought to be among the main causal factors of the crisis.<sup>13</sup> Arguably, the significance of banks have politicized the financial market incrementally, forcing policy makers to devote much of their attention to the specific topics of liquidity management rules, higher capital requirements and risk management calculations.<sup>14</sup> Therefore these are the main policy instruments to be assessed in this paper. Accordingly, the banking sector is an ideal field for a study of convergence theory. Banking regulation is a policy area characterized both by a high pressure for globalization and a history of nationally diverging systems and mechanisms.<sup>15</sup> There is evidence of incentives for both policy- convergence and divergence, providing the opportunity to examine how states react to these pressures.

An obstacle that this study encounters is the pace of policy change. As French historian Fernand Braudel writes: ‘new international financial systems are a product more of a medium-term ‘conjunctural’ historical process than of the fast paced ‘histoire evenementielle’ that preoccupies journalists.’<sup>16</sup> Such processes take time and we are likely only seeing the beginnings of regulatory

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<sup>10</sup> Hassel and Lutz (2010).

<sup>11</sup> Quaglia, L. (2010). *The 'Old' and 'New' Politics of Financial Services Regulation in the EU*. Observatoire Social Europeen. OSE.

<sup>12</sup> Carmen M. Reinhart og Kenneth S. Rogoff, *This Time is Different* (Princeton: Princeton University Press, 2009).

<sup>13</sup> Baker, A. (2010). Restraining Regulatory Capture? Anglo-America, Crisis Politics and Trajectories of Change in Global Financial Governance. *International Affairs*, 86 (3), pp. 647-663: 647

<sup>14</sup> Helleiner, E., & Pagliari, S. (2010). Crisis and the Reform of International Financial Regulation. In E. Helleiner, S. Pagliari, & H. Zimmermann (Eds.), *Global Finance in Crisis: The Politics of International Regulatory Change* (pp. 1-18). New York, NY, United States: Routledge.

<sup>15</sup> Andreas Busch, *Banking Regulation and Globalization* (Oxford University Press, 2009): 15

<sup>16</sup> Fernand Brandel as quoted in: Helleiner (2010): 627

regime change. To explain this, Ian Begg identifies three distinct phases of a crisis; ‘firefighting’, or rapid responses to prevent systemic collapse; ‘stimulation’, or recapitalizing the economy; and the more long-term recasting of regulatory systems phase that is currently unravelling.<sup>17</sup> As a result, this study will focus on the emerging tendencies in the fields of regulation policy, processes, and institutions framed. As such, this will necessarily be a study of short-term responses within the ongoing process of change, and will only generate hypotheses on whether the tendencies discovered can be considered indicators of more permanent changes in the practice of financial regulation.

### 3. Theoretical Concepts

#### *3.1 Understanding and operationalizing convergence*

Convergence theory assumes that financial globalization as the confrontation between global markets and state institutions enforces converging economic policies. Because this discussion will be narrowed down by a focus on financial regulation, it is first necessary to specify what the convergence of financial regulation entails. This deliberation will point to the factors that the following study will attempt to measure.

Leaning on previous research we can draw on the defining categories of others. The literature captures financial regulation under the umbrella term ‘policy convergence’.<sup>18</sup> This refers to the ‘convergence in the policies pursued (or the paradigms informing) particular states.’<sup>19</sup> According to Colin Bennett, policy can be understood to encompass *policy goals, policy content, policy instruments, policy outcomes, or policy style*.<sup>20</sup> As Bennett argues, however, the policies adopted by different governments oftentimes do not fit into the same ‘conceptual categories’,<sup>21</sup> and these categories should only be taken as guidelines. The analysis will draw on these guidelines to determine which factors to examine in assessing the final convergence criteria.

Daniel Drezner refines the definition of policy convergence in terms of the more measurable variable regulatory coordination. In the broad context such coordination entails the ‘codified

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<sup>17</sup> Begg, I. (2009). Regulation and Supervision of Financial Intermediaries in the EU: The Aftermath of the Financial Crisis. *Journal of Common Market Studies*, 47 (5), pp. 1107-1128: 1111

<sup>18</sup> Hay, C. (2004 May). Common Trajectories, Variable Paces, Divergent Outcomes? Models of European Capitalism under Conditions of Complex Economic Interdependence. *Review of International Political Economy*, 11 (2), pp. 231-262.

<sup>19</sup> Ibid.: 8

<sup>20</sup> Bennet, C. J. (1991 April). What is Policy Convergence and What Causes it? *British Journal of Political Science*, 21 (2), pp. 215-233: 218

<sup>21</sup> Ibid.: 218

adjustment of national standards in order to recognize or accommodate regulatory frameworks from other countries.’<sup>22</sup> This definition deviates from the standard definition of policy convergence as it addresses coordination rather than convergence. Coordination can occur when convergence does not, although not the other way around as it implies a deliberate effort. As will be pointed out in chapter ‘3.2 Theoretical Background’, defining convergence this way allows for a better understanding of national interests whilst still capturing the concept of convergence. In this understanding, coordination happens at the cost of one country and in favour of another rather than as the result of a common motion towards an abstract goal. In terms of observing convergence, the two terms are synonymous, as both would show up as a lack of variety between country policies.

Measuring variation in this variable relies on first assuming that a state’s ideal base to build on is its pre-existing national regulatory framework.<sup>23</sup> This assumption is based on a conclusion that regulatory issues are necessarily domestic problems before they reach the international stage.<sup>24</sup> To measure the differences in policy between the cases the study will rely on Legro and Moravcsik’s ‘two-step’ approach. This approach compares preferences shaped by domestic actors and institutions with international outcomes to determine their distribution along capabilities and power of the state actors in question.<sup>25</sup> In the banking sector, regulation tends to be subdivided into policies on capital requirements, leverage, liquidity and credit rating. As mentioned, the policy response to the crisis has been consequent in this. To find convergence (or alternately divergence) in the national standards it is therefore necessary to catalogue these factors. Bennet’s policy categories will be helpful in guiding this effort. Bank regulations are relatively specific and ample for comparison, however any differences are likely to be subtle due to their technical nature.

The next step is to assess how these policies recognize or accommodate the standards of other models. To do so we must first understand the nature of existing models. Regulatory convergence can be the result of coordinated harmonization through international law, economic integration,

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<sup>22</sup> Drezner (2007): 11

<sup>23</sup> Ibid.: 40

<sup>24</sup> Ibid.: 40

<sup>25</sup> Legro and Moravcsik (1999): 24

or domestic factors.<sup>26</sup> Other models could therefore include that of another state, in which case we would measure  $\sigma$ - Convergence, which ‘occurs if there is a decrease in variation of policies among the countries under consideration’,<sup>27</sup> or that of a transnational agreement, in which case the focus would be on  $\delta$ - convergence, or comparing countries’ changes in discrepancies to an exemplary model. This study has focused on the Basel Commission of Banking Supervision’s (BCBS) recommendations for banking regulation as the exemplary model and has furthermore chosen four countries that will be discussed in section ‘4.1 Case Selection’ as country models. It should be noted that convergence is a process rather than a fixed state,<sup>28</sup> and this study will refer to the study of countries ‘becoming’ more alike as opposed to existing similarities.

The next section will discuss the theoretical background to this discussion. It is necessary to evaluate this background before we can make any specific predictions. These predictions (see chapter ‘4.2 Expectations’) will relate to the discussed conceptualization of convergence.

### ***3.2 Theoretical Background***

#### ***Overview***

Structural convergence theory is the one dominating model that shapes the discussion of financial globalization. The perspective predicts policy convergence based on states’ interaction with the external force of globalism. Several influential studies point to the impotency of states in the face of this force.<sup>29</sup> The following discussion will provide an overview of previous research within this perspective and argue that it is deficient for understanding global bank regulation.

Convergence theory measures the phenomenon along a scale shaped by a linear understanding of both markets and institutions, where markets are understood to be expansionary, ‘disembedding’ logic and institutions are viewed as instruments aimed at ‘(re-)embedding’ the market and subordinating it to social and political purposes.<sup>30</sup> The school argues that state frameworks and

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<sup>26</sup> Holzinger, K., Knill, C., & Sommerer, T. (2008 Fall). Environmental Policy Convergence: the Impact of International Harmonization, Transnational Communication, and Regulatory Competition. *International Organization* , 62 (4), pp. 553-587: 556

<sup>27</sup> Knill, C. (2007 October). Introduction: Cross-National Policy Convergence: Concepts, Approaches and Explanatory Factors. *Journal of European Public Policy* , 12 (5), pp. 764-774: 769

<sup>28</sup> Bennett (1991): 219

<sup>29</sup> See for example Rodrik, D. (1997). *Has Globalization Gone Too Far?* Washington D.C., United States: Institute for International Economics; Strange, S. (1996). *The Retreat of the State: The Diffusion of Power in the World Economy*. Cambridge, UK: Cambridge University Press; Keohane, R. O., & Milner, H. V. (1996). *Internationalization and Domestic Politics*. Cambridge, UK: Cambridge University Press; Przeworski, A., & Wallerstein, M. (1988 March). Structural Dependence of the State on Capital. *The American Political Science Review* , 82 (1), pp. 11-29.

<sup>30</sup> Konings, M. (2008 October). European Finance in the American Mirror: Financial Change and the Reconfiguration of Competitiveness. *Contemporary Politics* , 14 (3), pp. 253-275: 254

practices of finance are converging and most accounts accredit this assimilation to the external pressures of global market competition.

A different and less explored way to understand economic globalization, and furthermore global financial integration, is to see it as a phenomenon contingent upon interests. This perspective, framed by the lens of game theory, sees global convergence as happening when the interests of powerful actors align but not otherwise. This, the international regulatory coordination theory, questions the main assumptions behind the dominating theoretical perspective by proposing that convergence is a deliberate consequence of interstate cooperation in the same way that divergence is the result of interstate competition. Both of these two perspectives will be discussed in the following deliberation.

### **3.2.1 The Structural Approach: Convergence theory**

The structural discussion typically takes as its starting point the return of free capital flows following the breakdown of the monetary system of Bretton Woods.<sup>31</sup> The freedom of capital to flow across borders opened up the possibility for capital owners to use the threat of exit to alter the political regulation of economic behaviour.<sup>32</sup> The mobility of capital in other words, shifted the balance of power ‘away from states and other holders of tangible and immobile assets and in favour of owners of more intangible and mobile assets such as financial capital’.<sup>33</sup> As we will see, in reaching this conclusion convergence theory relies on two assumptions that are difficult to verify.<sup>34</sup>

The theory argues that globalization leads to a convergence within policy fields that have traditionally been assumed to be distinctly characterized by national control; regulation of such policy areas as national environmental issues, health and safety issues, labour, and capital.<sup>35</sup> Assuming so drove many IPE scholars to envision the dominance of inter-state competition over domestic policy choices,<sup>36</sup> where the demand to stay eligible on the global market would drive

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<sup>31</sup> Raviv, O. (2011). *Speculating on Convergence: the Western European Finance-Led Growth Regime and the New European Periphery*. (Doctoral dissertation). Retrieved from Sussex Research Online website: <http://sro.sussex.ac.uk/>: 37

<sup>32</sup> Hirschman, A. O. (1970). *Exit, Voice, and Loyalty: Responses to Decline in Firms, Organizations, and States*. Cambridge, MA, United States: Harvard University Press.

<sup>33</sup> Raviv (2011)

<sup>34</sup> Drezner, D. W. (2001). *Globalization and Policy Convergence*. Oxford, UK: Blackwell Publishers:58

<sup>35</sup> *Ibid.*: 53

<sup>36</sup> Raviv (2011): 37

national governments to compete through deregulation. This competition amongst states will accordingly force states to regulate lower than or in line with the most liberalized states.

In this account, the deregulation and liberalization of markets leads to a narrowing of the differences between countries. The most common example is the ‘race to the bottom’ where states compete in deregulation. It is in this narrowing of interests that students in the structural vein examine convergence. States are predicted to converge in the assimilation of liberalization policies. As financial globalization integrates the markets of states, they are drawn to deregulation, restricted in political autonomy and necessarily converge in regulatory policies. As pointed out, this conclusion is suspended on two major assumptions.

The first assumption of the theory relates to universal state behaviour. Structural convergence theory is rooted partly in the theory of international trade, and partly in theories of interjurisdictional/intergovernmental competition.<sup>37</sup> Using a Heckscher- Ohlin model, Frieden and Rogowski argue that ‘exogenous trade’ (international market access to domestic actors) will lead to policy preferences amongst domestic actors.<sup>38</sup> Since capital is the most mobile factor of production, its owners possess the most viable threat of exit. Thus it is this sector that is most likely to assert control over the state’s political direction. Accepting universal state behaviour means that this will happen everywhere, and therefore policy is likely to converge across the board of states.<sup>39</sup>

Whilst evidence of policy convergence is lacking when considering specific examples, it is easier to spot in terms of operational deregulation.<sup>40</sup> This brings us to the second assumption, namely that states are not only willing to act in unison, but furthermore impelled to do so. According to the direction rooted in interjurisdictional competition, market forces will drive states to enter the race to the bottom as they compete for mobile capital. Presumably, actors of the global capital market are fully informed, and driven by a search for the highest net yield. As states integrate financially through the free flow of capital, they will be compelled by the desire to remain

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<sup>37</sup> Busch (2009)

<sup>38</sup> Frieden, J. A., & Rogowski, R. (1996). The Impact of the International Economy on National Policies: An Analytical Overview. In R. O. Keohane, & H. V. Milner (Eds.), *Internationalization and Domestic Politics* (pp. 25-47). Cambridge, NY, USA: Cambridge University Press: 42

<sup>39</sup> Busch (2009): 8

<sup>40</sup> Dombrowski, P. (1998). Haute Finance and High Theory: Recent Scholarship on Global Financial Relations. *Mershon International Studies Review*, 42 (1), pp. 1-28: 8

globally competitive and converge on a best practice of neo-liberalism.<sup>41</sup> The theory naturally concludes that state individualism in the implementation of financial regulation will be restricted by the globalized economy.

Hence, with regards to capital mobility, structural convergence theory makes two assumptions. The first is that states universally respond to the demands of capital, whereas other actors are deemed irrelevant. The second is that no state's market power can equal the force of global capital, and as such, capital rules.<sup>42</sup> In terms of global finance, convergence can be understood to imply a policy of *laissez-faire*, a policy that was prevalent in the escalation of the crisis.<sup>43</sup> As major banks' (capital owners) preferences are shaped by increasing global trade and exit threats are made, states should relax the grip of regulation on such deciding factors as capital reserve demands, risk- modelling and taking, and market discipline.\*

As the discussion around the global crisis has pointed out however, it is difficult to verify the second assumption, the limitation of state autonomy. With this in mind, it becomes more interesting to study the first assumption- that states only respond to the demands of capital. If markets do not dictate state behaviour, it is likely that this first assumption needs to be reinterpreted. Such a reinterpretation should focus on how financial policies are shaped in individual states to determine whether these policies represent other sectors of society. Assessing the interests of other actors would open the analysis to occurrences of divergence.

### 3.2.2 Addressing the assumptions

Colin Hay proposes that structural studies are too broad and should specify in order to capture the contingencies of convergence.<sup>44</sup> In a separate analysis, Daniel Drezner proclaims that they lack the 'capacity to explain variation in convergence outcomes'.<sup>45</sup> The discussion tends to neglect the state at the same time as emphasizing continuity over change by focusing on global economic pressure.<sup>46</sup> In other words, it could be construed that the perspective neglects other interest-shaping actors than capital owners. This method cannot explain the presence of divergence. Or

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<sup>41</sup> Colin Hay (2004)

<sup>42</sup> Drezner (2001): 58

<sup>43</sup> Baker (2010)

\* Collectively the three pillars of banking regulation according to Basel II

<sup>44</sup> Hay (2004)

<sup>45</sup> Drezner, D. W. (2005). Globalization, Harmonization, and Competition: the Different Pathways to Policy Convergence. *Journal of European Public Policy*, 12 (5), pp. 841-859: 842

<sup>46</sup> Schmidt, V. A. (2009 July). Putting the Political Back Into Political Economy by Bringing the State Back In Yet Again. *World Politics*, 61 (3), pp. 516-54: 516

Raviv synthesizes these findings in concluding that the central question behind convergence scholarship, the juxtaposition of markets with socio-political institutions, neglects the political and institutional proliferation of financial market relations.<sup>47</sup> In Raviv's view then, the study of convergence should take place within a study of how frameworks and institutions shape power-relations.

Raviv draws inspiration from the ideas of Martijn Konings in his study of strategy emulation. Konings's analysis suggests that convergence is the result of purpose driven political promotion rather than structurally imposed conditions.<sup>48</sup> This suggests that, rather than result in perfect assimilation, convergence will happen as a result of willing cooperation up to a point. Drezner emphasizes this perspective in his claim that deliberate convergence, or policy harmonization takes place only as long as it does not collide with the interests of one of the important actors.<sup>49</sup>

### **3.2.3 The international regulatory coordination model**

To answer the structural theories' lack of 'capacity to explain variation in convergence outcomes', Daniel Drezner suggests using game theory. To do this, however, we have to break with the continuum of disembedding markets and reembedding institutions; financial globalization has to be understood in terms of state interests. States practice strategic emulation, through which convergence is a process not characterized by institutional linkages and systemic rigidity but rather as the strategic acceptance or reluctance of global dynamics.<sup>50</sup> In this view, financial globalization is not synonymous with an abstract, external process that confronts national institutions, but rather represents the competition between institutionalized norms, relationships and mechanisms.<sup>51</sup> It should, as an addendum, be noted that this does not mean, as in the theoretical stream known as variegated capitalism,<sup>52</sup> that state preferences are path dependent, but rather that they are dynamic and respond to outside factors. Financial regulation will in this case represent these preferences. Using the dilemma found in the following table it should be possible to examine the divergence of global economic governance:

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<sup>47</sup> Raviv (2011): 44

<sup>48</sup> Konings (2008): 262

<sup>49</sup> Drezner (2005): 842

<sup>50</sup> Konings (2008): 254

<sup>51</sup> *Ibid.*: 257

<sup>52</sup> See for example Hall and Soskice (2001)



**Table 1: The coordination game**<sup>53</sup>

		<b>State B</b>	
		Switch to country A's standards (a)	Retain national standards (b)
<b>State A</b>	Retain national standards (a)	Coordinate at A ( $\pi$ , $\pi - d$ )	No coordination (0, 0)
	Switch to country B's standards (b)	No Coordination (-d, -d)	Coordinate at B ( $\pi - d$ , $\pi$ )

$\pi$  = benefits from regulatory coordination  
 $d$  = adjustment costs of switching standards

The framework turns its focus on the benefits and costs of convergence, suggesting the possible presence of divergence despite global market forces. The costs of convergence are understood to reflect the price of internal structural and systemic changes in addition to external political and economic pressures. Conversely, benefits relate to economic and political gains of integrated markets. Consequently, adjustment costs are a function of the ability of a domestic actor to use exit rather than voice in its reaction to global coordination.<sup>54</sup> The greater the investment of local actors in the status quo, the greater the cost of exit to these actors and therefore the greater the power of the political voice. However, on the other hand, globalization can also increase the threat of exit of certain domestic sectors, and in this way, the theory recognizes the importance of capital owners. To sum up, globalization increases the rewards for policy coordination, but also affects the costs of coordination in a likewise manner, thus giving incentives for both types of behaviour.<sup>55</sup>

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<sup>53</sup> Drezner (2005): 845

<sup>54</sup> Drezner (2007): 5

<sup>55</sup> Ibid.: 5

When domestic policy changes take place, other nations respond, possibly creating a global dynamic for change.<sup>56</sup> However, if this dynamic is to be successful, it is likely to need collective action.<sup>57</sup> In an expanded, multi-actor version, the model reviews this possibility. If the actors diverge in their regulatory standards, this would further result in regulatory competition where leading actors would try to amass as many allies to their competing sides.<sup>58</sup> The globalization of finance is, according to this view then, not best described as the confrontation between institutions and markets, but rather as the confrontation between different institutional models of finance.<sup>59</sup> Rather than study separate actors and how they react to exogenous pressures (markets), this model examines whether different actors have a ‘constitutive impact on the structural environment in which they operate.’<sup>60</sup> Essentially the model asserts that without great power concert, regulatory convergence will be incomplete and transnational attempts will be futile.

To conceptualize this, Drezner provides a model to predict the outcome of state relations whether they are of high or low conflict. This model divides outcomes into four different typologies of regulatory coordination, where alternative iii and iv amounts to convergence and i and ii to divergence:

**Table 2: Typology of Regulatory Coordination**<sup>61</sup>

		Divergence of interests between great powers and other international actors	
		<i>High conflict</i>	<i>Low conflict</i>
Divergence of interests among great powers	<i>High conflict</i>	i) Sham standards	ii) Rival standards
	<i>Low conflict</i>	iii) Club standards	iv) Harmonized standards

<sup>56</sup> Dombrowski (1998): 12

<sup>57</sup> Bryant, R. C. (1987). *International Financial Intermediation*. Washington D.C., United States: Brookings Institution: 141

<sup>58</sup> Drezner (2005): 850

<sup>59</sup> Grahl and Teague 2005, as referenced in Konings (2008): 256

<sup>60</sup> Konings (2008): 257

<sup>61</sup> Drezner (2007): 72

This framework is useful as a supplement to the coordination game. To understand how countries act in regulating banks we must first understand the nature of the overarching international outcomes. As this model shows, the success of international governance will indicate the degree of inter-state conflict. It will therefore add a relevant foundation to the study of policy divergence.

The model is furthermore appropriate because it has been used to explain global financial regulation previously.<sup>62</sup> This previous study concerned the international forum for bank regulation, the Basel Committee on Banking Supervision (BCBS) as one of its cases. In contrast to the present paper however, it reviews the committee prior the recent membership expansion. The analysis identified global banking regulation with the club standard typology. Such ‘clubs’ or smaller cooperative bargaining units (as opposed to large multinational organizations) are more likely to conclude in convergence due to the concord between the limited members.

The Committee has historically been particularly limiting in its membership. Referring to this, the earlier study points to low conflict between states, due to the club coordination between the members. However, recent events, most importantly the expanded membership of the BCBS, denote a shift in the international governance environment that suggests a higher degree of conflict, or divergence, between states. This shift is important to the argument that there is divergence in state regulation. The typology framework will be useful in highlighting this development.

### ***3.2.3.1 Benefits to the proposed model***

The model assumes, much in the same way as the realist perspective, that understanding international regulation translates to understanding great power preferences and capabilities. These capabilities derive from the size of an actor’s internal market. However, it deviates in arguing that preferences originate in the domestic political economy, or the visible adjustment costs that occur due to regulatory cooperation.<sup>63</sup> This allows for three propositions: first, that it is possible that actors rationally choose to not coordinate; second that larger market size

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<sup>62</sup> Drezner (2007): 122

<sup>63</sup> Ibid.: 32

governments can influence the regulation of globalization through coercive power; and thirdly, that disparities in capabilities or market size among the great powers are of minimal importance- they cannot coerce each other.<sup>64</sup>

Besides addressing some of the faulty assumptions of convergence theory, there are some benefits to this perspective that ought to be pointed out that apply specifically to this analysis. Most significantly, it is flexible to changes as it can develop theories regarding both policy process and outcomes. Therefore it is ideal for analyzing the immediate transition brought forth by the crisis. The financial turmoil impacted state interests, something that can be hard to apprehend using the limited lens of convergence theory. The international coordination model conceptualizes convergence as a measurable variable in terms of state interests, and is therefore much better suited to understanding the phenomenon.

The discussion of benefits and costs allows the analysis to focus on the specific situation for each country case where actors might vary in terms of their influence. This can shine a light on potential country differences despite equivalent exposure to economic integration. This means that we can examine the effects of both exit threats and voiced opinions. We can thus evaluate whether states converge or diverge in a method less general than focusing mainly on market structures.

Lastly its focus on great powers will allow the analysis to concentrate on a smaller number of state examples, yet generate broader hypotheses. This is because the model expects smaller powers to align themselves with those greater powers that best manage to sway them using either coercion or incentives to influence their cost/benefit equation. This condition could also be understood to be a weakness in the model; Drezner's original study has been criticized for neglecting important internal differences within a great power such as the EU.<sup>65</sup>

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<sup>64</sup> Ibid.: 33

<sup>65</sup> Zimmermann, H. (2010). Varieties of Global Financial Governance? British and German Approaches to Financial Market Regulation. In E. Helleiner, S. Pagliari, & H. Zimmermann (Eds.), *Global Finance in Crisis: The Politics of International Regulatory Change* (pp. 137- 152). New York, NY, United States: Routledge: 123

## 4. Cases and Expectations

### 4.1 Case Selection

In choosing countries the important factor is to select cases that fit into the theoretical framework. As mentioned, the intended definition of globalization is in terms of state interaction rather than as and external force demanding state adaptation. This perspective lends itself to the principles of ‘incorporated comparison’. Developed by Phillip McMichael, this type of comparison considers a ‘whole’ or a governing system by analyzing its ‘parts’.<sup>66</sup> The strength of this viewpoint is that it does not assume that the international system exists independent of nation states, nor that these factors are stagnant or path dependent units of analysis. This lets the analysis focus on state interests and how they influence global divergence or convergence. To capture this perspective and observe the way the parts, in this case countries, constitute the whole, or the global regulation of banks, the study will use the two-step analysis as discussed in section ‘3.1 Understanding and operationalizing convergence’.

To find cases that accord with the research question and the relevant theory, there are certain conditions that need to be controlled for. This means that the countries must be big actors with anticipated international influence. Furthermore, they must be advanced economies with a globally integrated financial sector. In order to examine regional effects there would also have to be representatives of different regions. The following country cases fulfil these demands: The United Kingdom, Germany, USA, and Canada (although Canada is in this case by far the less influential member, it is included nonetheless to provide a more complete explanation of North American banking to add to the regional dimension of the analysis).

The countries chosen can for the purposes of this analysis be considered equal in integration with the global economy. They are all functioning democracies that use an open capitalist approach to organize their economic activity. All four countries are members of the group of 20 (and the previous group of 8), and as such leading actors in the global economy. Thus we can control for the influence of economic integration. As an additional aspect, they represent two different regions, North America and Europe. This major difference, along with other discoveries will be

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<sup>66</sup> McMichael, P. (1990 June). Incorporating Comparison Within a World-Historical Perspective: An Alternative Comparative Method. *American Sociological Review*, 55 (3), pp. 385-397: 386

considered in the discussion of how the representatives choose to interact, be it through competition or coordination.

As conventional cases in convergence study analyses, Germany and UK are leading members of the EU on separate sides of the monetary union. This makes them interesting as they represent similar interests through their EU membership, but differ in financial policy as suggested by their position on the monetary union. It will be important to take into account the influence of the EU in forming national policies. Both countries also represent two sides of the varieties of capitalism school, Germany as a representative of the coordinated market economies (CMEs) and the UK as the prime example of a liberal market economy (LME).<sup>67</sup>

Canada and the US are both members of NAFTA and representatives of the North American region. The US holds considerable sway over its northern neighbour, but Canada is known as a sound economic actor with considerable normative influence. Furthermore, the crisis has affected Canada less severely, indicating that it should be influential in the financial restructuring. It should also be interesting to compare North American coordination to that of its transatlantic competitor the EU.

One concern with using Canada and the US is that they are both examples traditionally included in the LME group and both are considered Anglo-American type economies. As we will discover however, they differ significantly in their approach to banking regulation in a way that suggests that general categorization does not give a complete picture. For example, Canadian banking regulation is highly concentrated, more prudent, and generally more successful as compared to regulation in the US. Although developed from liberal self-regulation, Canada's banking regulation is evidently an outlier in terms of the amount of coordination that its LME label would predict. As a result, Canada's position has arguably not been weakened along with that of the US and UK and the disillusionment with Anglo-American liberalism.

Using the two-step design in assessing these countries involves the following procedure. The first step draws on Bennet's policy categories to identify the actors and institutions that are included in the formation of state preferences. The second step assesses these preferences in terms of state

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<sup>67</sup> Hall and Soskice (2001): 8

power and how they are reflected in inter-state interaction.<sup>68</sup> This method couples well with the theoretical framework, as its strength is a flexible approach to multiple influencing variables. A weakness of the method will be, as in any qualitative assessment of convergence, the difficulty in generalizing the findings. However, the aim of the study is to point at recent developments rather than provide definitive answers, as it is too close in temporal proximity for such conclusions anyways.

## ***4.2 Expectations***

Using these cases, this study will test the assumption that there has been convergence in global bank regulation. According to the proposed framework, there are two major indicators we would have to observe to do so, the coordination of global governance and state policy interests. The coordination of global governance, in light of regulatory typologies, would indicate the presence of convergence or divergence by pointing to the level of conflict. The individual policy interests of states can then be used to assess state similarities and differences. To observe, as this study hypothesises, divergence in bank regulation we should find conflict at the international governance level as well as differences in the specific policy factors.

Firstly, to gain an understanding of convergence through coordination at the international level the analysis will examine the BCBS. To see policy divergence, the model would predict a paradigm shift in the Committee's modus operandi. The first accord suggests a high degree of club coordination. However, with its increased membership it appears that Basel no longer automates such confined coordination of international standards. This would suggest that, depending on the degree of conflict, the inter-state coordination of bank regulation is evolving towards one of the three other typologies, sham standards, rival standards, or harmonized standards. This points out that the relationship between states is also changing, and could indicate divergence in policies.

The breakup of club standards would suggest an increased opportunity for state competition, which would be observed through a variety in banking regulation between the chosen cases. As mentioned, the regulation of banking is a highly technical field that relies on detailed definitions of specific requirements. In measurable terms, there should therefore be variety in the policy

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<sup>68</sup> Legro, J. W. (1996 March). Culture and Preferences in the International Cooperation Two-Step. *The American Political Science Review*, 90 (1), pp. 118-137: 118

goals, instruments, and contents related to capital requirements, liquidity minimums, leverage standards, and credit rating of the four observed cases. These factors are chosen based on the findings in '2. Global upheaval: Crisis and power shifts' that show their importance to bank regulation policies. Whether policy differences are pronounced would depend on inter-state relationships. Thus they would be more distinct in some cases than others. If, on the other hand, we observe that states are willing to recognize and accommodate policy changes that reflect the interests of other states we would have to question the hypothesis.

The financial foundation of the US has been shaken and therefore we should see a decline in the stability of this leadership role. One possible way this could be reflected is in Washington's ability to dictate Basel negotiations and the policies of other nations. Furthermore, to observe divergence, we would expect the US to have the most recognizable and autonomous model due to its market size. This would be reflected in policies highly connected with the policy goals for its banking sector. However, in previous events, the US has been successful in promoting its policy goals at the international level. If this was to repeat itself it could indicate that states will not diverge, and lead to concerns with the hypothesis.

Canada, as the lesser regional power would not openly challenge the policies of its neighbour at the international stage. However, if there were regulatory divergence, Ottawa would be expected to ensure the possibility of maintaining its individual supervisory model. This is particularly due to the stability of its preferred model as seen through Canada evading most of the severities brought on by the crisis in other countries. This being said, because of its market size, Canada is the case most susceptible to coercion from other states. We could therefore observe this in the form of convergence if Canada was unsuccessful in protecting its policy autonomy.

The GFC has likely altered the ratio of costs to benefits, and in the case of the US and the UK, leveraged in favour of the benefits to changing the status quo due to the failure of the Anglo-American financial model. We should therefore see this have an effect on the global stage, particularly concerning the smaller power, the UK. This would indicate a significantly decreased role of the UK, perhaps also so within the EU. If the relationship between costs and benefits is sufficiently influenced to support it, we could see cooperation within the EU that would be substantial enough to challenge the US. This would depend on the differences between particularly the UK and Germany. The decreasing role of the US should generate an incentive for



EU cooperation and a regional convergence between the two European actors that would indicate a global divergence between the Union and the US.

## 5. Data

### 5.1 Basel

The following section will discuss the role of the Basel Committee in coordinating the international reform. After discussing the specific responsibilities and purposes of the BCBS, and furthermore, the negotiation process, the section will conclude that there has been a decisive shift in the Committee's relevance that indicates a higher degree of conflict between states. This finding will be a useful supplement to the discussion of policy aspects in the next section.

One possible way for regulators to stagnate the impetus to compete through financial deregulation is to coordinate internationally.<sup>69</sup> Individually, as pointed out by proponents of convergence theory, domestic regulators are trapped in a prisoners dilemma: 'if they impose regulatory costs on financial firms that other countries fail to impose, they make their institutions less competitive in the world marketplace.'<sup>70</sup> Ethan Kapstein refers to this particular example as the regulator's dilemma.<sup>71</sup>

Drezner suggests that in the face of opposition, as in the prisoner's dilemma, like-minded states will attempt to form club IGOs (see table 2 in section '3.2.3 The international regulatory coordination model'). These intergovernmental organizations have membership requirements that exclude or limit the participation of dissenting countries, essentially forming a club for like-minded countries. In mediating the regulator's dilemma of global banking, the group of economic powers (Gs) has previously successfully collaborated through the Basel Committee on Banking Supervision (BCBS). A part of the presumption that there is convergence in global banking is the finding that the BCBS has in these cases been an especially good example of such a club.<sup>72</sup> In the midst of the recent crisis, states again turned to Basel to attempt to coordinate the regulatory

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<sup>69</sup> Hellwig, M. (2010). *Capital Regulation After the Crisis: Business as Usual?* Max Planck Institute for Research on Collective Goods. Bonn: Max Planck Institute for Research on Collective Goods.

<sup>70</sup> Kapstein, E. B. (1989 Spring). Resolving the Regulator's Dilemma: International Coordination of Banking Regulations. *International Organization*, 43 (2), pp. 323-347: 326

<sup>71</sup> Ibid.

<sup>72</sup> Drezner (2007): 122

reform. Therefore the agreement will in this case be a way to conceptualize model for  $\delta$ -convergence.

All three rounds of Basel negotiations have occurred somewhat related to financial crises, including the latest third round. The initial agreement established two noteworthy trends of banking regulation; capital reserve requirements as the most important feature of regulation, and a shift away from regulatory systems to supervisory systems of Bank oversight.<sup>73</sup> The second round continued the focus on the first regulatory pillar, capital reserves, but relinquished the power to set requirements to the banks themselves through the ‘advanced internal ratings-based’ (A-IRB) approach.<sup>74</sup> Furthermore, the second round established two other pillars of international bank regulation: risk- modelling and market discipline.<sup>75</sup> The recent third round reemphasized the focus on capital reserve requirements, but also introduced an innovative focus on countercyclical incentives.<sup>76</sup>

The third, most recent, attempt to coordinate through Basel was announced on 12 September 2010, and approved by the G-20 on 12 November the same year.<sup>77</sup> The revisions introduce new definitions of capital composition and quantity, capital conservation buffers, countercyclical buffers, leverage ratio, and liquidity standards.<sup>78</sup> The implementation of these standards will adhere to very different timing, with capital requirement standards coming into play in early 2013 and other indicators from 2018 and onwards.<sup>79</sup> This will have its implications for the effect of Basel, particularly in Europe where banks are faced with severe capital restraints.

The main policy trends of Basel III are stricter capital reserve requirements\* and new standards for liquidity and leverage.\*\* Its purpose is to address Committee findings that banks had, under

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<sup>73</sup> Tarullo, D. K. (2008). *Banking on Basel: The Future of International Financial Regulation*. NW, USA: Peter G. Peterson Institute for International Economics: 15

<sup>74</sup> Ibid.: 139

<sup>75</sup> Levingson, M. (2010). Faulty Basel. *Foreign Affairs*, 89 (3), 76-88: 3

<sup>76</sup> As opposed to incentives for the boom-and bust cycle as analysts claimed to be found in focus of the previous rounds. See for example Baker, A. (2010). Restraining Regulatory Capture? Anglo-America, Crisis Politics and Trajectories of Change in Global Financial Governance. *International Affairs*, 86 (3), pp. 647-663

<sup>77</sup> Delahaye, B.P. (2011). Basel III: Capital Adequacy and Liquidity After the Financial Crisis (Short Paper). Retrieved from Harvard Law website: <http://www.law.harvard.edu/programs/about/pifs/llm/select-papers-from-the-seminar-in-international-finance/llm-papers-2010-2011/delahaye.pdf>: 7

<sup>78</sup> Ibid.: 8-10

<sup>79</sup> Tropeano, D. (2011 Summer). Financial Regulation After the Crisis. *International Journal of Political Economy*, 40 (2), pp. 47-62: 54

\* A common equity (core Tier 1) requirement of 4.5%, raising the minimum total capital to 7%, plus two new requirements- a capital conservation buffer (2.5%) and a counter cyclical buffer adding to this required minimum. (source: Linklaters. (2010 September). *The Basel 3 'Safety Net' Higher Capital Requirements, New Liquidity Rules and Transitional Arrangements Confirmed*. Retrieved 2011, 15-April from Linklaters: <http://www.linklaters.com/Publications/20100913/Pages/Index.aspx>)

the previous Basel II regime, excessive freedom to decrease their equity to perilous levels.<sup>80</sup> It needs to be added, however, that the new requirements were not overhauled to be systemically different from Basel II; note for instance, as one of the major criticisms of Basel points out, that for institutions such as those deemed ‘too big to fail’, new capital requirements are no higher than those reserves reported right before these institutions failed.<sup>81</sup> Hellwig finds that the committee was unwilling to move outside its traditional framework or consider any ‘thorough overhaul’.<sup>82</sup> Essentially, the accord looks to continue the focus on individual bank stability rather than a system-wide approach,<sup>83</sup> and arguably it missed any meaningful use of the policy window the crisis provided.<sup>84</sup> To conclude, as *Financial Times* analyst Martin Wolf finds, ‘...the mountain of Basel has laboured mightily and brought forth a mouse.’<sup>85</sup> The committee has not been successful in addressing the more pertinent and contentious issues that are more systemic in nature.

### 5.1.1 Club negotiation

Why should an analysis of state policy preferences consider Basel? These accords do not merely come as a result of tug-o-war between regulators and the banking sector but rather highlight how internal interests do influence how states behave. The following discussion will underline the importance of such interests. The way that states act at the international arena indicates divergence in a way that convergence theory fails to address. As seen below, the account will bring the discussion back to the more important actors as discussed in the theoretical framework, namely states.

In discussing the negotiation process of Basel, the paper will only touch on the first and third round. This is not only for the sake of brevity, but also more importantly because they make the most ample comparison in terms of circumstances. Both cases emerged out of financial crises that seriously damaged the bargaining leverage of the US. Obviously the second negotiation round was influential to the Committee’s evolution, however this evolution is more noticeable when

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\*\* The on trial new global liquidity standards (liquidity coverage ratio and net stable funding ratio) and an on trial 3% leverage ratio based on Tier 1 capital. (source: Walker, G. A. (2011). Basel III Market and Regulatory Compromise. *Journal of Banking Regulation* , 12, pp. 95-99.)

<sup>80</sup> Hellwig, M. (2010). *Capital Regulation After the Crisis: Business as Usual?* Max Planck Institute for Research on Collective Goods. Bonn: Max Planck Institute for Research on Collective Goods.

<sup>81</sup> Boone, P., & Johnson, S. (2011 10-April). *The Future of Banking: Is More Regulation Needed?* Retrieved 2011 19-April from FT.com: [www.ft.com/cms/s/0/e0c55688-63b2-11e0-bd7f-00144feab49a.html](http://www.ft.com/cms/s/0/e0c55688-63b2-11e0-bd7f-00144feab49a.html)

<sup>82</sup> Hellwig (2010): 2

<sup>83</sup> Acharya, Kulkarni and Richardson (2011): 153

<sup>84</sup> Wignall, A. B., & Atkinson, P. (2010). *What Will Basel III Achieve*. GMF. The German Marshall Fund of the United States: 3

<sup>85</sup> Wolf, M. (2010 14-September). *Basel: The Mouse that Did Not Roar*. Retrieved 2011 15-April from Financial Times: [www.ft.com/cms/s/0/966b5e88-c034-11df-b77d-00144feab49a.html](http://www.ft.com/cms/s/0/966b5e88-c034-11df-b77d-00144feab49a.html) basel the mouse that did not roar

presented through the contrasting narratives of the first and third round. Not discussing the details of the second round allows the account to better highlight the shifting role of the BCBS.

#### **5.1.1.1 Basel I**

Reports from the first Basel accord point to a confining club-like organization dominated by the US and the UK. This account is included because it indicates a strong role for state cooperation and coercion that contrasts today's situation.

Particularly one incident, the 1980s debt crisis, had an important say in the momentum of this process. Much like the recent crisis, it exposed insufficiencies in the US banking system that led the United States to champion 'functionally equivalent' regulation of banking.<sup>86</sup> These worries, in addition to concerns that multilateral efforts through the BCBS were moving too slow, led the Federal Reserve Board to move unilaterally by proposing an upgraded capital adequacy regime.<sup>87</sup>

However, the failure of the US regulatory system left it in a weak position to enforce a general adoption of its model.<sup>88</sup> This moved the US to seek out a 'coalition of the willing,' to which the UK responded.<sup>89</sup> In addressing the weaknesses in the regulatory system, Congress emulated new methods from particularly Britain, likely leading the two countries closer together in terms of regulatory similarities.<sup>90</sup> Britain, on the other hand was going through an internal struggle between its financial institutions and bank system reformers.<sup>91</sup> Actually, the interest of both countries converged in several important ways, something that was crucial to this cooperation.<sup>92</sup> Seeing the win-win opportunity in cooperation, the willing coalition quickly penned down a bilateral agreement on banking regulation in 1987.<sup>93</sup>

It was indeed this bilateral agreement that injected the necessary fuel to the multilateral discussions at Basel.<sup>94</sup> Charles Goodhart describes the agreement as a 'powerplay' from the two main financial centres that pressured the other BCBS members into subscribing to the idea of

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<sup>86</sup> Goodhart, C. A. (2011). *The Basel Committee on Banking Supervision: A History of the Early Years, 1974-1997*. Cambridge, UK: Cambridge University Press: 155

<sup>87</sup> Goodhart (2011): 164

<sup>88</sup> Kapstein, (1989): 338

<sup>89</sup> Goodhart (2011): 167

<sup>90</sup> Kapsten (1989): 338

<sup>91</sup> Goodhart (2011): 168

<sup>92</sup> Kapstein, E. B. (1992 Winter). Between Power and Purpose: Central Bankers and the Politics of Regulatory Convergence. *International Organization*, 46 (1), pp. 265-287: 266

<sup>93</sup> Kapstein (1989): 339

<sup>94</sup> For a detailed overview, see Goodhart (2011) chapter 6C

coordinated banking regulation.<sup>95</sup> The alliance put pressure on the Japanese to cooperate with the US and on the European side, stifled the French and German attempt at promoting a European Commission agreement.<sup>96</sup> Although there are other possible factors involved it is quite clear from the records that the alliance between the US and the UK was a driving force in framing standards for bank regulation through the first Basel Accord.

### **5.1.1.2 Basel III**

The previous discussion of the first accord gives ample reasons for comparison to the most recent Basel round, particularly because the impetus for political involvement in both cases generated from an international banking crisis that had a severe effect on the US. However, there is one major difference between the first accord and the recent agreement, namely membership. Originally with membership limited to the G10 (exceptions given to Luxemburg and Spain), the Committee now comprises an expanded and diverse compound of all the members of the G20. Arguably, the BCBS has evolved from a club IGO to one of increased heterogeneity. This means that the threat of smaller powers amassing an opposition to the Committee's great members has increased, and thus the possibility of club coordination has decreased. This undoubtedly has an impact on the influence of the BCBS.

Speaking on the international regulatory agenda, Pagliari argues that the US, as a proponent of neoliberal ideas, continued to play an important role in the Committee, and that the crisis has not diminished its role notably.<sup>97</sup> Pagliari's discussion claims that any non-US (particularly European) impact on financial regulation would most likely be at the regional level because of this.<sup>98</sup> This is further reflected in a press statement made by the European Parliament, where the implementation rather than negotiation process of Basel is emphasized.<sup>99</sup> What this indicates is not a regulatory capture by the US, but instead the decreasing influence of Basel where there is more internal conflict and less pressure on standard compliance.

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<sup>95</sup> Goodhart (2011): 173

<sup>96</sup> Kapstein (1992): 266

<sup>97</sup> Pagliari, S. (forthcoming). *A Wall Around Europe? the European Regulatory Response to the Global Financial Crisis and the Turn in Transatlantic Relations*. Retrieved 2011 10-October from Stefanopagliari.net: <http://www.stefanopagliari.net/SP/Publications.html>: 5

<sup>98</sup> Pagliari (forthcoming): 5

<sup>99</sup> Karas, O. (2010, 09 14). *Basel III negotiations: Strong negotiation position for Parliament*. Retrieved 11 08, 2011 from EPP Group: <http://www.eppgroup.eu/press/showpr.asp?PRContentID=16472&PRContentLG=en&PRControlDocTypeID=1&PRControlID=9630>

Although US regulators have maintained a leading position at the transnational level through the Basel negotiation process,<sup>100</sup> their role has not been reflected through national acceptance and implementation.<sup>101</sup> Arguably the negotiation of the third accord has been marred by the previous withdrawal of US support for Basel II. In the most recent process, the US has again decisively turned to internal solutions. Conversely, the EU, which was instrumental in Basel II implementation,<sup>102</sup> is looking to coordinate with the help of Basel. In fact, the EU arguably stands the most to gain from global governance as it can provide a confine to structure the coordination of its members. The contrast between these two powers is a source of transatlantic tension.

The previous withdrawal of the US from Basel II has likely been detrimental to the most recent agreement.<sup>103</sup> The US disregard for the Committee's decisions conflicts with that of the other examples because the Committee is much more relevant to the EU in coordinating regional efforts and also to Canada as a venue for normative power. This has mostly affected US- EU relations. It can be argued that the conflict of relevance has caused a divergence between the US and the EU.<sup>104</sup> This is particularly due to the uncertainty regarding room for Basel implementation in the new US regulatory structure,<sup>105</sup> which demonstrates the continued intent by Washington to reserve itself from committing to the Committee's agreements. The split between the two influential actors is conceivably an important reason why the third round has been so reluctant to address the more contentious issues.

Although Canada is one of the original Committee members, the literature speaks little on its influence in these negotiations. Likely, Canada's involvement is hampered by the restraints it faces in openly challenging the US.<sup>106</sup> To understand Canada's role it is necessary to understand its internal focus. It is in Canada's interest to have as much policy autonomy as possible in order to allow it to continue its prudent and successful regulatory policies without being restricted,

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<sup>100</sup> Herring, R. J. (2007). The Rocky Road to Implementation of Basel II in the United States. *Atlantic Economic Journal* , 35 (4), pp. 411-429: 411

<sup>101</sup> *Ibid.*: 412

<sup>102</sup> Veron, N. (2012). Financial Reform After the Crisis: An Early Assessment (Working Paper No. 12). Retrieved from Peterson Institute for International Economics website: <http://www.iie.com/publications/wp/wp12-2.pdf>: 4

<sup>103</sup> Atlantic Council. (2010 October). *The Danger of Divergence: Transatlantic Cooperation on Financial Reform*. Retrieved 2011 8-November from Atlantic Council: [http://www.acus.org/files/publication\\_pdfs/403/ACUS\\_TR\\_Danger\\_Divergence\\_Report.pdf](http://www.acus.org/files/publication_pdfs/403/ACUS_TR_Danger_Divergence_Report.pdf): 19

<sup>104</sup> Delahaye, B.P. (2011). Basel III: Capital Adequacy and Liquidity After the Financial Crisis (Short Paper). Retrieved from Harvard Law website: <http://www.law.harvard.edu/programs/about/pifs/llm/select-papers-from-the-seminar-in-international-finance/llm-papers-2010-2011/delahaye.pdf>: 3

<sup>105</sup> *Ibid.*: 18

<sup>106</sup> Leblond, P. (2010-2011). Canada, the European Union, and Transatlantic Financial Governance. *International Journal* , 66 (1), pp. 57-72: 71

particularly by its neighbour. This makes Basel an important forum for gathering normative support for this preference.

The negotiation process of Basel III has already revealed deep-seated disagreements between its participants. This is emphasized by the individual action taken by several states in framing legislative initiatives even before the finalization of Basel III.<sup>107</sup> The focus on individual models has probably induced the previously mentioned reluctance to approach contentious systemic issues and rather emphasize elaborate technical solutions.<sup>108</sup> This variance in models is not consistent with the club typology, and it is clear that there has been a shift in the Basel regime. Due to this fragmented response, this latest effort has produced less relevant standards that only give the appearance of global coordination, standards that fall into the sham typology (see table 2 in section ‘3.2.3 The international regulatory coordination model’). It appears that the expanded membership of Basel has led to a more heterogeneous Committee where members are vary of delegating their decision making power. According to the typologies this should lead to a higher degree of inter-state conflict, in other words divergence.

## ***5.2 Country Cases***

The following section will examine the details of the policy goals, content, instruments, outcomes and styles of each case. Identifying these is the first step to the two-step analysis. They will later be compared, as part of the second step, in the analysis section. The aim of this detailed discussion is to create an inclusive picture of the status quo preferences of each country through examining, as Colin Bennett suggests, the different aspects of policy. As argued in this paper, the policies of these countries are noticeably divergent. The evidence of this will first be presented in this section, and then discussed in the following section, chapter ‘6. Analysis’.

The intention of chapter 5.2 is to present a detailed description of the empirical evidence in an organized fashion. The actual in depth analysis of this evidence will first be begun in the next chapter. The purpose behind this is to handle the presentation of the evidence as comprehensible as possible.

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<sup>107</sup> Helleiner, E. (2010). *The Limits of International Cooperation: Crisis Management and Regulatory Reform in Response to the 2007-2008 Financial Meltdown*. University of Waterloo. University of Waterloo: 18

<sup>108</sup> Porter, T. (2010). Risk Models and Transnational Governance in the Global Financial Crisis: the Case of Basel II and Credit Rating Agencies. In E. Helleiner, S. Pagliari, & H. Zimmermann (Eds.), *Global Finance in Crisis* (pp. 56-73). New York, NY, United States: Routledge: 57

It should also be noted that besides being guided by the policy categories presented in Bennett's study, this scope has also been limited on concerning which specific policy content to assess. This focus is based on the categories which have dominated the discussion of bank regulation and that have already been noted in section '2. Global upheaval: Crisis and power shifts' and section '5.1 Basel', namely capital requirements, liquidity, leverage, and credit rating. The fact that the discussion has been restricted in this way might be considered evidence of convergence, however, as both the discussion on Basel as well as the following data indicates, countries have noticeably different ways of framing these categories.

### **5.2.1 The Financial crisis**

The presentation will start with an outline of the major impacts of the financial crisis on each country case. The various ways the different countries were affected by the crisis is interesting to the discussion of policy convergence. Identifying which sectors were the most affected could provide insight to the nature of finance in each case, but also more importantly give an idea of shifts in country preferences that would be important to understanding their individual interests. We can use these crisis outcomes to help identify whether the subsequent responses have targeted the specific demands of individual countries or reflected a general convergent reform process. This will in turn be supporting evidence in whether or not there has been divergence. Essentially this section is trying to locate the keys to understanding the specific interests relevant to each case.

#### **5.2.1.1 The United States**

The US was essentially the epicentre of the first stage of the subprime crisis. The burdens of its costs suggest that the US could eye the benefits of change in its reform efforts. Amongst the factors leading to the crisis, many analysts point to three decades of steady deregulation in the US banking system. This reliance on market-making ideals helped promote financial innovation that resulted in the different investment vehicles so well documented in the aftermath. These instruments of financial innovation caused regulators and Wall Street insiders both to concede that "this time it's different".<sup>109</sup> A short account of the crisis shows that a large number of financial institutions managed to shift risks by 'exploiting loopholes in order to take an

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<sup>109</sup> Reinhart and Rogoff (2009): 214



undercapitalized highly leveraged one-way bet on the economy'.<sup>110</sup> A main reason this wager was possible was the breakdown of the Glass-Steagall Act, the legislation separating commercial from investment banks.<sup>111</sup> These regulatory failures collectively give incentives to fix a broken system.

The Dodd-Frank Wall Street Reform and Consumer Protection Act (henceforth DFA) is the one prominent and lengthy\* piece of regulative legislation that has been passed by the federal government in response to the financial collapse.<sup>112</sup> *The Economist* has described it as a suffocating ever-growing hydra of regulation,<sup>113</sup> and in many aspects it does represent a reversal of previous deregulation, including an appeal to again separate commercial and investment banks. On the other hand, the Act, in its inconclusiveness, can also be argued to compliment the established laissez-faire approach of the Obama administration.<sup>114</sup>

Broadly speaking, the post-crisis setting has found US banks in a better position in terms of capital adequacy contra their European counterparts. In terms of liquidity, however, the situation is slightly more problematic. The identified failures of the US financial system give the US a strong incentive for reform. These factors have obviously affected the international negotiations of common regulatory standards.<sup>115</sup>

### 5.2.1.2 Canada

In many ways, Canada emerged out of the '07/'08 crisis as the epitome of well managed banking, with little incentive to change. As in the great depression, none of its banks failed, and no bailouts were doled out.<sup>116</sup> The major way that the crisis impacted Canada was through a collapse in the short-term loan (asset-backed commercial paper) market,<sup>117</sup> and as such the only

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<sup>110</sup> Acharya, Kulkarni and Richardson (2011): 146

<sup>111</sup> Lim, M.M. (2008). Old Wine in a New Bottle: Subprime Mortgage Crisis- Causes and Consequences (Working Paper No. 532). Retrieved from The Levy Economics Institute website: [http://www.levyinstitute.org/pubs/wp\\_532.pdf](http://www.levyinstitute.org/pubs/wp_532.pdf): 14

\* 2, 319 pages requiring 243 new formal rules to be adopted by 11 different regulatory agencies, all within a year and a half of its passage (source: Acharya, V. V., Cooley, T. F., Richardson, M., & Walter, I. (2011). *Regulating Wall Street: the Dodd-Frank Act and the New Architecture of Global Finance*. Hoboken, NJ, United States: John Wiley & Sons, Inc: XII)

<sup>112</sup> Thompson, E. (2012). Dodd-Frank and Basel III's Skin in the Game Divergence and Why it is Good for the International Banking System. *The Global Business Law Review*, 2 (159), pp. 159-174: 2

<sup>113</sup> The Economist. (2012, February 18). Over-Regulated america. *The Economist*.

<sup>114</sup> Cooley, T. F., & Walter, I. (2011). The Architecture of Financial Regulation. In V. V. Acharya et al. (2011): 39

<sup>115</sup> Eubanks, W. W. (2010, October 28). *The Status of the Basel III Capital Adequacy Accord*. Retrieved October 24, 2011 from Congressional Research Service: <http://www.fas.org/sgp/crs/misc/R41467.pdf>: 9-10

<sup>116</sup> Bordo, M.D., Redish, A., & Rockoff, H. (2011). Why Didn't Canada Have a Banking Crisis in 2008 (or in 1930, or 1907, or...)? (Working Paper No. 17312). Retrieved from National Bureau of Economic Research website: <http://www.nber.org/papers/w17312>: 2

<sup>117</sup> Rousseau, S. (2009). Regulating Credit Rating Agencies After the Financial Crisis: the Long and Winding Road Toward Accountability (Research Paper). Retrieved from: [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1456708](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1456708): 4

government action necessary was to interfere as the lender of last resort.<sup>118</sup> In the end, no major legislation was passed in response to the crisis, as no major flaws to the Canadian system seemed to be exposed.

Economists point to innate Canadian conservatism, and maybe more importantly to superior Canadian regulation as reasons for the country's success.<sup>119</sup> In terms of post-crisis negotiations, this put Canada in an, at least ideologically, superior position compared to the other cases considered here. Financial downturn in the US and Europe has provided Canada not only with a moral soapbox, but furthermore also led to the expansion of Canadian financial institutions abroad, filling some of the voids of these countries' struggling financial markets.<sup>120</sup> To conclude the crisis did not lead to any remarkable changes to Ottawa's policy preferences.

### **5.2.1.3 The EU**

When considering Germany and the UK it is first imperative to understand the surrounding framework of bank regulation in the EU. The bargaining block that the union forms is an important aspect of the analysis and it is therefore necessary to examine the coherence of its framework and guiding principles with the policies of the two countries. It is, as referred to in the theoretical background, important to understand that the EU cannot be treated as a static unitary actor. Therefore this discussion of the EU is complemented with the subsequent discussions of two of its most important members.

The struggle between national autonomy and international markets and supervision is a major roadblock to the integration of financial regulation in the EU.<sup>121</sup> Therefore, the convergence or harmonization of the European banking systems has been a cornerstone in the effort towards the single financial market.<sup>122</sup> However, as opposed to the oft resorted to example of trade policy, finance policy has remained mainly in the national domain. This means that national authorities are more important drivers of policy in the case of finance.

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<sup>118</sup> Zorn, L., Wilkins, C., & Engert, W. (2009 Autumn). *Bank of Canada Liquidity Actions in Response to the Financial Market Turmoil*. Retrieved 2012 6-February from Bank of Canada of Review: <http://www.bankofcanada.ca/wp-content/uploads/2010/06/zorn.pdf>

<sup>119</sup> Bordo Redish and Rockoff (2011) and Leblond, P. (2011). A Canadian Perspective on the EU's Financial Architecture and the Crisis. In K. Hubner, *Europe, Canada and the Comprehensive Economic Partnership* (pp. 165-179). London, United Kingdom: Routledge: 3

<sup>120</sup> Hyman, S., Pennycook, C., Vesey, D., & Williams, N. (2011). Canada Chapter. In J. Putnis (Ed.), *The Banking Regulation Review*. London, United Kingdom: Law Business Research Ltd: 100

<sup>121</sup> or the trilemma in financial supervision, between a stable financial system, an integrated financial market, and independent national financial supervision. See Schoenmaker, D., & Oosterloo, S. (2005). Cross-Border Issues in European Financial Supervision. In *the Structure of Financial Regulation*. London, United Kingdom: Routledge.

<sup>122</sup> Pagoulatos, G. (1999). European Banking: Five Modes of Governance. *West European Politics*, 22 (1), pp. 68-94: 68

The EU has relied upon two main principles, decentralization and cooperation, based on hopes that coordination through committees and information exchange would promote integration.<sup>123</sup> Rather than to work towards a transfer of competence and authority to the EU level, the tactic has revolved around cooperative decentralization, with the hope that committees and information sharing procedures would lead to a better-integrated system.<sup>124</sup> This means that the main tools and responsibility for crisis management lies with national authorities rather than a collective EU institution.<sup>125</sup> Thus with the intensification of internationalization of EU banks there was no concomitant consecration of EU authority to regulate this.

It is not surprising that the EU was considerably ill prepared architecturally for the GFC. The crisis necessitated state action by demanding responses to the exposed fault lines in the regulation of global finance.<sup>126</sup> For Europe the major fault line was an inability to coordinate across borders, prompting two possible responses: ‘beggar-thy-neighbour solutions’, or enhanced, pragmatic European cooperation.<sup>127</sup> Simply stated, the systemic, cross-border nature of the crisis defied the structures of the Union. Two main concerns were thus confirmed; that surrounding the ability to manage liquidity without a lender-of-last-resort, and that on solvency and the arrangement for resolving cross-border banking crises.<sup>128</sup> These deficiencies have in recent times developed into a blooming bank crisis that threatens to engulf all of Europe and cause many to fear the destruction of the monetary union.

To conclude, the GFC has acted as a catalyst for change by exposing some of the more costly aspects of the current EU structure. Furthermore, with the dominating ideology in mind, the crisis has triggered a ‘cumulative backlash’ reaction to the failed Anglo-American experiment.<sup>129</sup> The global impact of this reaction has been increased by the expanded capacity of the EU due to its economic relevance.<sup>130</sup> To understand the viability of a common EU reaction it is first pertinent to examine its leading members.

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<sup>123</sup> Leblond (2011): 17

<sup>124</sup> Pisani-Ferry, J., & Sapir, A. (2010 йил April). Banking Crisis Management in the EU: an Early Assessment. *Economic Policy*, 25 (62), pp. 341-373: 346

<sup>125</sup> Ferry and Sapir, 347

<sup>126</sup> Begg (2009): 1107

<sup>127</sup> De Larisiere, as quoted in Begg (2009): 1111

<sup>128</sup> Pisani-Ferry and Sapir (2010): 343

<sup>129</sup> Posner, E. (2010). Is a European Approach to Financial Regulation Emerging from the Crisis? In E. Helleiner, S. Pagliari, & H. Zimmermann (Eds.), *Global Finance in Crisis: The Politics of International Regulatory Change* (pp. 108-120). New York, NY, United States: Routledge: 110

<sup>130</sup> Ibid.: 116

#### 5.2.1.4 The UK\*

Due to the nature of the British financial system, it was another epicentre of the GFC, initializing the breakout of the European facet of the crisis. This has given the UK perhaps the biggest incentive for change between it and Germany. Its government was forced to announce an \$850 billion stimulus package.<sup>131</sup> The British economy relies on its financial centre in London as its primary engine and any halt to its functions would be critical. Therefore the crisis, with its consequent disillusionment with the British regulatory model caused an internal re-evaluation within the UK policy-making elite.<sup>132</sup>

British banking regulation policy has therefore been decisively impacted by the financial collapse. The crisis has put financial regulation back on the political agenda. First with the bank run on Northern Rock in 2007, but later and more importantly with the evolution into the systemic crisis of October 2008. This development ‘widened the range of regulatory issues now commanding the attention of elected politicians, bringing the issue of the macro-stability of the whole banking system to public attention.’<sup>133</sup> This gave British regulators a pronounced incentive to a more system wide reform than for example Germany.

The years following the GFC have seen several substantial changes to the British banking system, but how do these relate to the political reliance on market forces? One trend stands out; the political demand for prudential regulation. For instance, former Prime Minister Brown publicly recognized the importance of the role of government as a result of the crisis.<sup>134</sup> Noticeably, the major proponents of this trend do, unlike Mr. Brown, appear to be outside of the formal spheres of influence. For example, former chairman of the British Financial Services Authority (FSA), Lord Turner has been a vocal spokesperson for prudential regulation and topping the Basel recommendations.<sup>135</sup> These interests have shaped the British reform process.

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\* In the course of this thesis, the UK and Britain will be used interchangeably and synonymously.

<sup>131</sup> Nanto, D. K. (2009, October 2). *The Global Financial Crisis: Analysis and Policy Implications*. Retrieved January 4, 2012 from Congressional Research Service: <http://www.fas.org/sgp/crs/misc/RL34742.pdf>: 58

<sup>132</sup> Moschella, M. (2011 March). Searching for a Fix for International Financial Markets: The European Union and Domestic Politico-Economic Changes. *Journal of Contemporary European Studies*, 19 (1), pp. 97-112: 108

<sup>133</sup> Froud, J., Moran, M., Nilsson, A., & Williams, K. (2010). Wasting a Crisis? Democracy and Markets in Britain after 2007. *The Political Quarterly*, 81 (1), pp. 25-38: 28

<sup>134</sup> Moschella (2011)

<sup>135</sup> See for example Hall, M. J. (2009). The Reform of UK Financial Regulation. *Journal of Banking Regulation*, 11 (1), pp. 31-75.

### **5.2.1.5 Germany**

As an export oriented economy, Germany was among the most affected countries (in terms of GDP decline) of the Global crisis.<sup>136</sup> Due to an increasing internationalization of assets (globally, not just within the EU region),<sup>137</sup> Germany's banking sector was also exposed. Therefore, Germany's financial system was quite substantially impacted by the crisis. In fact, around a quarter of Europe's write-downs were made by German banks.<sup>138</sup> One study shows that it was particularly the publicly owned parts of the sector that was hit by the GFC.<sup>139</sup>

Germany successfully managed to stave off a full-blown bank crisis by implementing system wide government guarantees and fiscal stimulus packages.<sup>140</sup> Despite the threat to its banking sector however, Germany has not championed many individual reforms following the crisis. Most of its efforts, as will become clear further on, have focused on influencing global and regional agreements. The decision to focus on the international level is likely influenced by Germany's dependence on a risk exposed bank system, which has little sway over global trends. However it is exacerbated by the corporatist nature of banking institutions that appear constrictive to Germany's domestic policy choices. Look for Germany's policies to be impacted by this constriction.

### **5.2.1.6 Findings**

Evidently there are some major differences in the way that the GFC affected each of our four examples. This has, as pointed out, shaped their reform demands in the post-crisis rebuilding process. According to the theoretical framework, these demands should be reflected in each country's policy interests. To observe divergence, we would need to see such policy interests codified into individual reform models rather than observe a strong consensus that reflect one country or model's particular interests. The following sections will take a closer look at whether this has occurred.

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<sup>136</sup> Zohlnhofer, R. (2011). Between a Rock and a Hard Place: the Grand Coalition's Response to the Economic Crisis. *German Politics*, 20 (2), pp. 227-242: 227

<sup>137</sup> Hardie, I., & Howarth, D. (2009). Die Krise but not La Crise? The Financial Crisis and the Transformation of German and French Banking Systems. *Journal of Common Market Studies*, 47 (5), pp. 1017-1039: 1026

<sup>138</sup> Ibid.: 1028

<sup>139</sup> Hau, H., & Thum, M. (2009). Subprime Crisis and Board (In-)Competence: Private vs. Public Banks in Germany (Working Paper No. 2640). Retrieved from Centre for Economic Policy Research website: [http://www.cepr.org/meets/wkcn/9/976/papers/hau\\_thum.pdf](http://www.cepr.org/meets/wkcn/9/976/papers/hau_thum.pdf)

<sup>140</sup> Zohlnhofer (2011): 231

## 5.2.2 The banking sectors

The following segment will aim to outline the policy style and subsequently the goals of each country example. The different countries practice different economic policies that rely on a variety of financing structures. The most apparent differences lie between the UK and the US on one side and Germany on the other, with the Canadian system somewhere in-between. The UK and US boast a tradition of lightly regulated yet highly complex financial activity, whereas authorities in Germany and Canada have taken a more involved stance. This section will further supplement the previous findings of different country interests.

### 5.2.2.1 The US

Of the country cases reviewed here, banks may be the least important to the financing structure of the US. The US banking sector is highly fragmented both in regulation and in structure. There are a vast number of financial institutions both at the state and federal levels- a commercial bank can operate under either a national bank charter or a state bank charter.<sup>141</sup> This makes the banking sector a comparably large one. It also creates a necessity for distinctions between federal and state governance. Over the course of recent decades, these legal separations of federal and state governed banks have diminished and the system is today well integrated thanks to legislation allowing for extensive nationwide mergers.<sup>142</sup> Nevertheless, there remains a ‘multiplicity of banking regulators and a resulting dispersion of authority’ in the sector.<sup>143</sup>

The sector is further differentiated from the other cases by the previous separation of commercial and investment banks by the Glass-Steagall Act. Rather than allow universal banking, the US system developed into two separate financial services industries.<sup>144</sup> This separation was repealed by a process of deregulation ending in 1999, opening for a system that until now has remained more or less universal.<sup>145</sup> As a result of this evolution through separation, financial institutions have had to rely on their creativity and innovation to access especially the mortgage market.

As mentioned, the oversight of US banks has over recent decades, and through several administrations, been contained by a political culture promoting deregulation. Notwithstanding,

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<sup>141</sup> DeYoung, R. (2009). Banking in the United States. In A. N. Berger, P. Molyneux, & J. O. Wilson (Eds.), *The Oxford Handbook of Banking*. New York, NY, USA: Oxford University Press: 2

<sup>142</sup> Dam, K.W. (2010). The Subprime Crisis and Financial Regulation: International and Comparative Perspectives (Working Paper No. 517). Retrieved from: [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1579048](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1579048): 8

<sup>143</sup> Ibid.: 10

<sup>144</sup> Ibid.: 9

<sup>145</sup> Ibid.: 9

the American banking system is decidedly characterized by government involvement. For instance, it was the Roosevelt administration that established the government-sponsored enterprises (GSEs) such as the Federal National Mortgage Association (more commonly referred to as Fannie Mae), a decision that essentially created a secondary mortgage market.<sup>146</sup> Private financial institutions exploited this market through the use of innovative mortgage-backed securities (mortgages made into tradable assets).

One of the GSEs, the Federal National Mortgage Corporation (Freddie Mac) played a founding role in the establishment of the securitized mortgages market by being a trade vehicle exempt from legal, regulatory and tax issues that prohibited the private sector.<sup>147</sup> Freddie Mac and other GSEs established the governmental arm in what was to become a parallel ‘shadow banking’\* system.<sup>148</sup> Through deregulation this market was increasingly privatized, and finally with the dissolution of the Glass-Steagall Act of 1999, it changed from a ‘buy and hold’ to a ‘buy to trade’ market.<sup>149</sup> The drive to create more tradable assets led to the eventual lending boom and ‘subprime’ mortgages which were furthermore supported by the GSEs.\*\* In this way, government involvement in the banking sector had created a false market that arguably deserves its share of the blame for the GFC.

This link between the public and private sectors has continued to be important both through and after the crisis. Consider, as an example, the inherent guarantees attached to the Federal government’s ‘too big to fail’ bailout policy. On the other hand, one aspect of the banking sector that has (to an extent) changed is the categorization of regulatory authority based on legal naming rather than function. It was this categorization that allowed parallel mortgage markets to exist, as institutions were able to function outside of the authority of banking regulating agencies through

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<sup>146</sup> Kregel, J. (2008). Changes in the U.S. Financial System and the Subprime Crisis (Working Paper No. 530). Retrieved from The Levy Economics Institute website: [www.levyinstitute.org/pubs/wp\\_530.pdf](http://www.levyinstitute.org/pubs/wp_530.pdf): 4

<sup>147</sup> Ibid.: 7

\* Shadow banking in its broadest definition ‘includes such familiar institutions as investment banks, money-market mutual funds (MMMFs), and mortgage brokers; some rather old contractual forms, such as sale and-repurchase agreements (repos); and more esoteric instruments such as asset-backed securities (ABSs), collateralized debt obligations (CDOs), and asset-backed commercial paper (ABCP). (source: Gorton, G., & Metrick, A. (2010, Fall). Regulating the Shadow Banking System. *Brookings Papers on Economic Activity* , pp. 261-312: 261)

<sup>148</sup> Deyoung (2009): 9

<sup>149</sup> Kregel (2008): 10

\*\* Although these had been transformed and further privatized to be less reliant on government funding. It should be noted that a government guarantee was generally accepted to be implied. See: Dam (2010) and Kregel (2008).

name only. The DFA has changed this by providing authority for ‘clear, strong and consolidated supervision of ... any financial firm- regardless of legal form...’<sup>150</sup>

As a final note on the US banking sector, it should be mentioned that Basel II has yet to be implemented by many of its members. On one hand this could imply that banks will be more affected by the simultaneous attempt to transition to both Basel II and III.<sup>151</sup> On the other hand it could also imply that Basel III will be disregarded much in the same way that its predecessor has been treated. The fragmented nature of the US banking sector points to a diverging national preference that should affect the policies Washington pursues. This will be further discussed in section ‘5.2.3 Main Regulatory Bodies and Legislation’.

### **5.2.2.2 Canada**

Canada has traditionally relied on a bank dominated financing structure, however market-based financing has increased in importance in the run-up to the GFC.<sup>152</sup> As compared with the US, Canada hosts a relatively simple banking system. Its banking sector is distinguished the domination of six large banks\* with an integrated nationwide branch network.<sup>153</sup> This network is furthermore exposed to limited external competition, which leads to the other characteristic of the sector, namely the reduced incentives to take risks.<sup>154</sup> This structure has evolved due to the Canadian federal government relying on the major banks to cooperatively regulate themselves. The resulting importance of these six major institutions has led to a regulatory scheme targeted at managing these major banks, particularly in terms of market influence.<sup>155</sup>

With regards to the international stage of financial governance, Canada has traditionally looked towards the US, and furthermore acted as a broker between its neighbour and Europe.<sup>156</sup> The Canadian method of regulation is characterized by prudential concerns, not only with the health

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<sup>150</sup> Acharya et al. (2011): 23

<sup>151</sup> EMEA Banking. (2010 November). *Basel III and European Banking: Its Impact, How Banks Might Respond, and the Challenges of Implementation*. Retrieved 2011 7-December from McKinsey&Company: [http://www.mckinsey.com/client-service/Financial\\_Services/Knowledge\\_Highlights/~/media/Reports/Financial\\_Services/Basel%20III%20and%20European%20banking%20FINAL.ashx](http://www.mckinsey.com/client-service/Financial_Services/Knowledge_Highlights/~/media/Reports/Financial_Services/Basel%20III%20and%20European%20banking%20FINAL.ashx): 6

<sup>152</sup> Bank of Canada. (2011, June). *Financial Systems Review: June 2011*. Retrieved March 6, 2012 from Bank of Canada: [http://www.bankofcanada.ca/wp-content/uploads/2011/06/fsr\\_0611.pdf](http://www.bankofcanada.ca/wp-content/uploads/2011/06/fsr_0611.pdf): 29

\* five of which have been ranked top 20 by Moody’s most recent listing of bank capitalization (source: Greenwood, J. (2011, May 9). *Canadian banks are world’s strongest: Bloomberg, Moody’s*. Retrieved March 16, 2012 from Financial Post:

<http://business.financialpost.com/2011/05/09/canadian-banks-are-worlds-strongest-bloomberg-moodys/>)

<sup>153</sup> Ratnovski, L., & Huang, R. (2009). *Why Are Canadian Banks More Resilient?* (Working Paper No. 152). Retrieved from International Monetary Fund website: <http://www.imf.org/external/pubs/ft/wp/2009/wp09152.pdf>

<sup>154</sup> Ibid

<sup>155</sup> Keefe, B. W., & Sodhi, S. S. (2011). Canada. In D. E. Shapiro (Ed.), *Banking Regulation: In 27 Jurisdictions Worldwide* (pp. 15-19). London, UK: Getting the Deal Through: 17

<sup>156</sup> Leblond (2010-2011): 58



of the major banks, but furthermore with depositor protection.<sup>157</sup> Therefore, Canadian requirements often impose higher capital standards and lower leverage values than seen in other cases.<sup>158</sup> Also, Canada has not adopted the concept of universal banking, in effect separating between banking, insurance, and securities dealing sectors.<sup>159</sup> The freedom to do so is promoted by the reduced competition and risk taking in the banking sector. According to its policy preferences, Canada should look to protect its status quo in order to maintain these inherent values.

A final note on the structure of the banking sector and its subsequent regulation regards the political tectonics of Canada. Whilst regulatory oversight of financial institutions lies at the federal level, provinces often compete amongst each other in attracting investment. In recent years this has led to a situation in which the Canadian Bankers Association (CBA) has voiced its concern over provincial governments encroaching on federal duties by attempting to stake out individual bank regulatory schemes.<sup>160</sup> The CBA notes this fragmentation as a concern to be taken seriously in upcoming federal discussions on financial market regulation.<sup>161</sup>

### **5.2.2.3 The EU**

The EU's financing structure is heavily reliant on bank lending; a situation that reflects German preferences more than it does the UK's. Although the integration of finances (particularly banking) has been held as a pertinent goal by EU policy-makers since the emergence of the single market, this achievement has been slow to be obtained.<sup>162</sup> Schoenmaker and van Laecke find that only in recent years has the 'long expected' cross-border merger wave in Europe started.<sup>163</sup> Contrasted with banking sectors in other continents, however, European banks are significantly more internationalized, primarily due to their cross-border activity within the EU.<sup>164</sup>

The EU has established somewhat of a precedence of incorporating Basel recommendations into regional legislation through the Capital Requirements Directive (CRD), a two-part legislative

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<sup>157</sup> Hyman, Pennycook, Vesey and Williams (2011): 89

<sup>158</sup> Ibid.: 89

<sup>159</sup> Ibid.: 89

<sup>160</sup> Canadian Bankers Association. (2011, August). *Submission to the House of Commons Standing Committee on Finance: 2011 Pre-Budget Consultations*. Retrieved October 10, 2011 from Canadian Bankers Association:

[http://www.cba.ca/contents/files/submissions/sub\\_20110812\\_pbs\\_en.pdf](http://www.cba.ca/contents/files/submissions/sub_20110812_pbs_en.pdf): 5

<sup>161</sup> Ibid

<sup>162</sup> Largely due to tax and regulatory differences across countries, see Pisani- Ferry and Sapir (2010): 344

<sup>163</sup> Schoenmaker and van Laecke (2007) as referenced in Pisani-Ferry and Sapir (2010)

<sup>164</sup> Ferry and Sapir, 345

piece.\* The CRD achieves longevity through a process of amendments to update its relevance and is due to be implemented in 2012. In fact, EU authorities have also attempted to use the GFC as a policy driver for increasing financial supervision.<sup>165</sup> However, it seems the EU has thus far held back on reforms to its banking regulatory scheme. It appears to have neglected key regulatory flaws, focusing rather on the securities sector.<sup>166</sup>

The European bank sector has one more significant common factor, namely the high level of financialization, or the exposure to risk. This was among the principal causes of the severity of the financial crisis in the EU.<sup>167</sup> This same problem has also limited both the UK and Germany in their regulatory response to the crisis.<sup>168</sup> Germany and the UK are traditional antipodes that continually find themselves at opposite ends of negotiations within the Union. In their financial framework, Germany has typically been reliant on state guidance, whereas Britain is seen as having the weakest state involvement.<sup>169</sup> Furthermore, EU members have (since the second half of the 1980s) converged around the German-type universal banking model.<sup>170</sup> Britain and Germany diverge in their acceptance of universal banking, with Britain being the reluctant one.\*\* To recapitulate this process, regulatory harmonization has most likely led to a EU framework with a lower regulatory threshold for the purpose of accommodating all its members.<sup>171</sup>

#### **5.2.2.4 The UK**

Hodson and Mabbett argue in agreement with Peter Hall that the financial regulatory system of Britain has developed within a distinct paradigm.<sup>172</sup> Accordingly, this paradigm directs British policy decisions through a distinct path that differs from paths found in other countries. This path can be described as ‘market-making’, a policy path that emphasizes the regulatory approaches of competition and market efficiency.<sup>173</sup> One important characteristic of the British paradigm is an

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\* EC directive 2006/48/ and EC directive 2006/49/

<sup>165</sup> Begg (2009)

<sup>166</sup> Quaglia 2010b

<sup>167</sup> Buckley, J., & Howarth, D. (2010). Internal Market: Gesture Politics? Explaining the EU's Response to the Financial Crisis. *Journal of Common Market Studies*, 48, pp. 119-141: 131

<sup>168</sup> Ibid.: 132

<sup>169</sup> Pagoulatos (1999) 71

<sup>170</sup> Ibid.: 76

\*\* The UK operated with a separated market until the series of reforms in 1986 nicknamed the ‘big bang’ allowed banks to undertake a wide range of securities operations. See Pagoulatos, 76

<sup>171</sup> Garcia, G. G., & Nieto, M. J. (2005). Banking Crisis Management in the European Union: Multiple Regulators and Resolution Authorities. *Journal of Banking Regulation*, 6, pp. 206-226: 210

<sup>172</sup> Hodson, D., & Mabbett, D. (2009). UK Economic Policy and the Global Financial Crisis: Paradigm Lost? *Journal of Common Market Studies*, 47 (5), pp. 1041-1061.

<sup>173</sup> Quaglia (2010a):7.

inherent paradox: Although British authorities have become known for taking a distanced stance in regulating the financial market, the political structure is also characterized by a comparative ease in implementing fundamental reforms.<sup>174</sup>

Britain's financing system revolves around the trading centre referred to as 'the City'. This geographically concentrated political powerhouse binds and shapes much of the financial political decisions in the UK.<sup>175</sup> However, the British market-based system does not overpower the UK's reliance on banks, and in terms of financing, one can claim that the UK is equally market-based and bank-based. Politically speaking, however, the financial centre dominates. British promotion of deregulation can be understood as a reaction to City demands and economic patriotism.<sup>176</sup> The relationship between the City and regulators has historically been highly informal, and continues to be so even under a more formalized set of rules.<sup>177</sup>

The ruling British ideology has stressed the importance of self-regulation or in the worst case, cooperative regulation without adversarial confrontation.<sup>178</sup> The preferred method of policy evolution has in this sense been more reactive than anticipatory,<sup>179</sup> meaning that regulation has developed as a response to crises rather than as a form of prevention. Froud claims that this method excludes 'democratic forces' from the government of financial markets except for in the few instances of financial turmoil.<sup>180</sup>

As seen in the discussion of the financial crisis, its effects have opened another window of opportunity for politicizing the regulation of Britain's financial market. The principal policies that govern the British banking sector are being updated with the reform of some of the important regulatory bodies that are due to be implemented in 2013.<sup>181</sup> As the Financial Policy Committee (FPC) and the Prudential Regulation Authority (PRA) is replacing the current Financial Services Authority (FSA) there will also be an expected switch from principles-based regulation to a focus on outcomes and more intensive scrutiny.<sup>182</sup> The FSA and the independent Bank of England have

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<sup>174</sup> Busch (2009): 160.

<sup>175</sup> Ibid.: 123

<sup>176</sup> Morgan, G. (2012). Supporting the City: Economic Patriotism in Financial Markets. *Journal of European Public Policy*, 19 (3), pp. 373-387.

<sup>177</sup> Busch (2009): 158

<sup>178</sup> Froud et al. (2010): 26

<sup>179</sup> Busch (2009): 158

<sup>180</sup> Froud et al. (2010): 27

<sup>181</sup> Petch, T. (2011). United Kingdom. In *Banking Regulation in 27 Jurisdictions Worldwide* (pp. 155-163). London, UK: Getting the Deal Through: 155

<sup>182</sup> Ibid.: 159

been important pillars of the light-regulation system. Predictably therefore, there will be a breakdown of the previous separation of elected politicians and financial regulators alongside the breakdown of the FSA and the independent system of Bank regulation.<sup>183</sup>

The Vickers reform is perhaps the main reform expected to affect the fundamentals of British banking. The proposal by Sir John Vickers in his independent Commission's report will split big banks and place separate retail operations behind a capital wall, or ringfence.<sup>184</sup> This is intended to be an insurance against the problem of systemically important institutions. Because the City is such a global financial hub, its institutions far exceed the guarantor ability of the British government. With a ringfence in place, the authorities will be able to guarantee citizens' savings whilst remove themselves from investment branches. It is important to note that this does not implicate the end of universal banking in Britain in the same way that Volcker does for the US. The British reform has been distinctly divergent in adhering to the specific policy demands put on its regulators following the crisis.

#### **5.2.2.5 Germany**

One important difference between the UK and Germany is that where the UK's financial system centres on the City, the German system centres on its banking sector. In the German system, banks act as the intermediary between the financial market and firms.<sup>185</sup> This gives quite extensive power to German banks, which is channelled through a corporate system. It also means that Germany has a long-term oriented credit market and is therefore more reliant on CRAs than a liberal market economy (LME) like Britain.<sup>186</sup> Most notably, the German position on banking regulation is heavily influenced by its three-pillared banking system, consisting of a commercial sector, a public law administered sector, and a cooperative sector.<sup>187</sup>

These pillars are separated by different financial structures, legal status and governance systems.<sup>188</sup> As follows, each sector will have its own position to lobby. For example, Germany has traditionally been a proponent of tighter regional financial regulation, a position that is contested by the public sector banks. As a result of the local interest and coordination of banking

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<sup>183</sup> Froud (2010): 28

<sup>184</sup> Goff, S., & Parker, G. (2011 19-December). *Coalition to accept Vickers 'in full'*. Retrieved 2012 5-January from Financial Times: <http://search.proquest.com/docview/912010163?accountid=12870>

<sup>185</sup> Zimmermann (2010): 125

<sup>186</sup> Ibid.: 126

<sup>187</sup> Busch (2009): 92.

<sup>188</sup> Hardie and Howarth (2009): 1019.

and the traditional strength of the public banking sector, the federal government has thus resigned itself to a comparatively hands-off approach.<sup>189</sup> Nevertheless, the German government has long supported the elimination of the three-pillared system, and one way the GFC has influenced regulation in Germany has been to provide an opportunity for the government to achieve this goal.<sup>190</sup>

Germany has not been impregnable to financial globalization. Its financial sector has developed a disadvantage in its ability to raise venture capital because of the economy's reliance on banks.<sup>191</sup> Accordingly, financial globalization has helped force through reforms of uncompetitive sectors that significantly drive the banking system towards the areas of investment banking.<sup>192</sup> Concomitantly, Germany's political leaders have adamantly pursued global regulation to keep newly established financial actors under control.<sup>193</sup> Apparently, an inherent policy preference for Germany is to seek supranational solutions to its confining financial structure.

#### **5.2.2.6 Findings**

The different composition of each country's banking sector is an important indicator of that country's policy preferences. This section has shown that each of these cases have different ways of organizing their financial structure that also dictates the importance of banks in that structure. This demonstrates that each country will have different preferences regarding the regulation of banking, based on the influence of the sector in that specific case. This banking sector variation supports the argument that there is divergence in global banking regulation.

#### **5.2.3 Main Regulatory Bodies and Legislation**

We will examine the policy content and instruments through discussing the main bodies and legislation. The different banking systems rely on different acts and regulatory bodies to govern them. Of the country cases in this analysis it is the US that has undergone the most radical changes in terms of legislation. Its newly adopted Dodd-Frank Act is the lengthiest of its kind to date. However, in terms of structural adjustments to regulatory bodies, it is arguably Britain that has seen the most change with the dismantling of its FSA (although Germany has begun some

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<sup>189</sup> Ibid.

<sup>190</sup> Wilson, J., Jenkins, P., & Masters, B. (2010 14-September). *Basel III Sets Stage for Landesbank Reform*. Retrieved 2011 11-April from FT.com: <http://www.ft.com/cms/s/0/a3158900-c026-11df-b77d-00144feab49a.html>

<sup>191</sup> Zimmermann (2010): 129

<sup>192</sup> Ibid.: 131

<sup>193</sup> Ibid.: 8, 131

similar reforms to consolidate power over its supervisory authorities). Germany's stance has been consistent in that it is pursuing its changes at the regional level before implementing any individual changes. Canada on the other hand has been relatively quiet in its reform implementation, reflective of its policy interests as described in the previous sections. The purpose of this section is to show the variety of policy instruments drawn on by the four countries. These instruments are convincingly consequent to the policy interests already discussed.

### **5.2.3.1 The US**

#### *National Bank Act*

The base legislation that governs the regulation of federal banks is the National Bank Act of 1863, which has been amended on several occasions. It is important to note that this Act concerns those banks categorized as *national* banks. As of such, there is another regulated market between state banks that is also somewhat coordinated at the national level.

#### *OCC, the Fed, and the FDIC*

At the federal level, the Office of the Comptroller of the Currency (OCC) serves as the primary regulator and supervisor of national banks.<sup>194</sup> State-chartered banks have to relate to the Federal Deposit Insurance Corporation (FDIC), as the authority for non-members of the Federal Reserve System,<sup>195</sup> or alternately, the Federal Reserve (the Fed), for those that are members of the system.<sup>196</sup> In addition, the Office of Thrift Supervision (OTS) supervises 'thrifts' or savings and loan association, whilst the National Credit Union Administration (NCUA) handles credit unions.<sup>197</sup> According to the DFA these agencies now all operate under the scrutiny of the new Financial Stability Oversight Council.

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<sup>194</sup> DeYoung (2009): 2

<sup>195</sup> FDIC. (2009 5-April). *FDIC Mission, Vision, and Values*. Retrieved 2011 5-December from FDIC: <http://www.fdic.gov/about/mission/index.html>

<sup>196</sup> Dam (2010): 11

<sup>197</sup> *Ibid.*: 11

## *The DFA*

The DFA is the most recent regulatory piece of legislation and will thus reflect the framework that these regulatory bodies exist within. It has been described as the ‘most ambitious and far-reaching overhaul of financial regulation since the 1930s (and the imposition of the Glass-Steagall Act).<sup>198</sup> Its underlying tasks are to: identify and regulate systemic risk; put an end to ‘too-big-to-fail’; expand the responsibility and authority of the Federal Reserve (Fed); Restrict discretionary regulatory interventions; to reinstate a limited form of Glass-Steagall (the Volcker Rule); and to regulate the derivate market.<sup>199</sup>

On the other hand, the Act does not take any steps towards consolidating the aforementioned fragmented regulatory and authority framework.<sup>200</sup> Viral Acharya and his team of analysts conclude that the result of the Act’s shortcomings leaves ‘implicit government guarantees’ in certain pockets of the financial sector that will, through new financial innovation, lead to repeat problems of capital allocation further down the road.<sup>201</sup> One prominent example where this is perhaps most evident is the failures of the Act to reform the GSEs.<sup>202</sup> Indeed, banks are already poised to turn to such ‘financial alchemy’ to create elbowroom in the more stringent capital requirements,<sup>203</sup> and the shadow banking system is expected to grow as institutions conjure up ways to evade DFA definitions.<sup>204</sup>

The criticisms of the Act all seem to boil down to the conclusion that it does not incorporate a clear or consistent approach to the regulation of the financial sector due to not being decisive on the question of what banking is and what constitutes a bank.<sup>205</sup> In several parts, the Act regulates a financial firm by its form (bank) rather than function (banking). This feature will prevent the Act from dealing well with the new organizational forms likely to emerge in the financial sector as well as from meeting the altered demands of global capital markets.<sup>206</sup>

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<sup>198</sup> Acharya et al. (2011): 1

<sup>199</sup> Ibid.: 6

<sup>200</sup> Ibid.: 8

<sup>201</sup> Ibid.: 9

<sup>202</sup> Ibid.

<sup>203</sup> Braithwaite, T. (2011 25-10). *Banks Turn to Financial Alchemy in Search For Capital*. Retrieved 2011 26-10 from Financial Times: <http://search.proquest.com/docview/900446830?accountid=12870>

<sup>204</sup> The Economist. (2012, February 18). Too Big Not to Fail. *The Economist*.

<sup>205</sup> Cooley and Walter (2011): 45

<sup>206</sup> Acharya et al. (2011): 8

The DFA is ambiguous on most accounts and is said to leave more questions than answers. In effect, the Act is a guideline for future regulators and therefore leaves several specifics unanswered. Yale Law School's Jonathan Macey points out a poignant difference between more traditional pieces of legislation which directs itself at people and the DFA which performs more like an outline directed at bureaucrats instructing them to make 'still more regulations.'<sup>207</sup> Indeed, a major fear concerning the Act is the prevalence of blank spaces, which demand that regulators fill in further detail.<sup>208</sup>

### **5.2.3.2 Canada**

#### *Bank Act*

The primary statute governing Canadian banking is the federally legislated Bank Act. This act gives the federal government the exclusive jurisdiction to impose requirements on the banking sector.<sup>209</sup> The act is governed under a policy of review and revision on a five-year interval, although the latest review was instigated two years ahead of schedule, in 2010.<sup>210</sup> Besides that, the Canadian reform has been unsurprisingly stagnant.

#### *OSFI*

The main body responsible for the day-to-day oversight of regulation is the Office of the Superintendent of Financial Institutions (OSFI/ the superintendent). It is within this office that requirements for capital adequacy, liquidity and leverage are set. The consolidation of financial supervisory authority in the single body of the OSFI is a major contributing reason as to why the Canadian system fared so well in the GFC.<sup>211</sup> Furthermore, it is a key feature that distinguishes Canada from its neighbour.

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<sup>207</sup> The Economist (2012b)

<sup>208</sup> The Economist (2012a)

<sup>209</sup> Keefe and Sodhi (2011): 15

<sup>210</sup> Ibid.: 16

<sup>211</sup> Lebond (2011): 13



### 5.2.3.3 *The EU*

The EU has an advisory role when it comes to financial regulation. Most of its recommendations are developed within either the European System of Central Banks (the ESCB) or the Committee of European Banking Supervisors (CEBS).<sup>212</sup> Marring the specificity of EU recommendations however, is the fact that these advisory bodies are quiet irrelevant due to the diversity in the institutional structures for supervising finances at the national level of the various members.<sup>213</sup>

#### *The Banking Directives and Supervisors*

EU banking is guided by the banking directives, the first of which was issued in 1977.<sup>214</sup> For the purpose of this discussion, the Capital Requirement Directive (CRD) is the most important as it is the document that directly relates to the Basel process. Besides these overarching directives, however, there are various new bodies that have recently emerged.

Prior to the GFC, there were a limited amount of authoritative regulatory bodies relevant to bank and even financial regulation in the EU. The financial crisis has in some regards strengthened the work to establish functioning regional financial supervision. Although no plethora of institutions similar to the US system has emerged, there are a few new regulatory bodies that have the potential to consecrate regulatory oversight at the regional level in Europe. These are collectively categorized under the caption European Supervisory Authorities (ESAs).

#### *ESAs*

These ESAs have been given the task of consolidating the supervision of banks.<sup>215</sup> This regional supervision is to take place through ‘supervisory colleges’- flexible, permanent fora for collective supervision, headed by the home country and including countries hosting active branches of the institution in question.<sup>216</sup> The ESA’s role with regards to these colleges is to ensure they apply and implement EU law consistently across financial institutions.<sup>217</sup> The ESA has in this role replaced previous advisory committees and provide a more concrete tool for regional

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<sup>212</sup> Ibid.: 17

<sup>213</sup> Carcia (2005): 212

<sup>214</sup> Ibid.: 210

<sup>215</sup> Deutsche Bundesbank. (2009 September). *Amendments to the new EU Capital Requirements Directive and the Minimum Requirements for Risk Management*. Retrieved 2011 12-November from Deutsche Bundesbank:

[http://www.bundesbank.de/download/volkswirtschaft/mba/2009/200909mba\\_en\\_amendments.pdf](http://www.bundesbank.de/download/volkswirtschaft/mba/2009/200909mba_en_amendments.pdf): 70

<sup>216</sup> Ibid.: 70

<sup>217</sup> Alford, D. (2010). Supervisory Colleges: The Global Financial Crisis and Improving International Supervisory Coordination. *Emory International Law Review*, 24, pp. 57-82: 64.

authorities.<sup>218</sup> Prior to the GFC, such coordination was lacking and this led to an array of responses during the crisis.<sup>219</sup> The EU has therefore since worked to increase the appeal of the supervisory college approach to financial supervision.

### *EBA*

The colleges will be imperative in shaping a common regulatory culture. One way to strengthen their ability to do so is through the application of the newly established European Banking Authority (EBA). The EBA's mandate outlines it as an arbitrator between national supervisors, mostly restricted to issuing non-binding policy recommendations.<sup>220</sup> It will operate through the colleges as an observer to encourage institution-wide views regarding prudential supervision.<sup>221</sup> Two major concerns for the proponents of EU supervision however, is the inability of the EBA to issue binding decisions and the restrictions brought onto EBA independence in the face of state appeals.<sup>222</sup>

Although the newly constructed financial institutions have little formal authority to limit the capabilities of national regulation, it appears that states in the Union are working towards establishing new policy routes as alternatives to individual action. Particularly the supervisory colleges could support this effort by providing viable solutions to host/home conflicts. Developments within the CRD however, may hamper these efforts as the roles of home countries, or the 'consolidating supervisor', have been enhanced.<sup>223</sup> As home countries are likely to be more affected by institutions' exit threats, their interests are likely to conflict with international cooperation demanding prudent regulation. The conflict between international cooperation and nationalization of regulation seems to control the ability of the EU to formalize its authoritative power. For all purposes it seems the EU is intent upon continuing to rely on hopes for cooperation by coordination through committees. The outcome depends on the future of the newly established institutions, particularly the EBA. As one hopeful commentator has pointed

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<sup>218</sup> Linklaters. (2011 18-February). *International Reform of Financial Regulation: Overview and Implementation Timetable*. Retrieved 2011 12-November from Linklaters: [http://www.linklaters.com/pdfs/mkt/irfr/FR\\_Timetable\\_Download\\_version\\_FINAL.pdf](http://www.linklaters.com/pdfs/mkt/irfr/FR_Timetable_Download_version_FINAL.pdf): 88.

<sup>219</sup> Alford (2010): 65

<sup>220</sup> Ibid.: 68

<sup>221</sup> Ibid.: 69

<sup>222</sup> Ibid.: 73

<sup>223</sup> Christopoulos, D., & Quaglia, L. (2009). Network Constraints in EU Banking Regulation: The Capital Requirements Directive. *Journal of Public Policy*, 29 (Special Issue 2), pp. 179-200: 186

out; although given little substantial authority at the onset, such actors can be expected to play an increasing role in future EU regulatory developments.<sup>224</sup>

#### **5.2.3.4 The UK**

##### *FSA/ FPC and PRA*

The major reform following the GFC was the abandonment of the FSA for the creation of new institutions, the FPC and the PRA, both lodged within the Bank of England. This not only marks the return of financial regulation to the central bank, but also a strengthening of supervisory tools. The FPC will identify risks in the financial system, but also has the mandate to take action against those risks.<sup>225</sup> Analyst Robert Peston sees the possibility that the creation of the FPC with its ‘unprecedented powers over financial institutions’ marks the death of a ‘laissez-faire ideology’ that preceded the crisis.<sup>226</sup> The PRA’s objective will be to contribute to the promotion of the stability of the British financial system, a task envisaged performed through a judgment-based supervisory approach.<sup>227</sup> Although the reform rendered the supervisory institution less independent it is important to note, for comparison to other states’ practice, that supervision will still be held within one institution.

In this case, the caveat is to be found within the interpretation of these ‘unprecedented powers’. The FPC’s mandate diffusely restricts the committee from taking actions it considers detrimental to the ‘capacity of the financial sector or to the growth of the UK economy.’<sup>228</sup> With the questionable new direction of UK financial policy it seems too early to make any decisive conclusion on the future of the FPC.

##### *The Banking Act*

This is the act that governs UK banks. It now refers to the 2009 revision of previous documents, and thus to a decided change in philosophy regarding regulation.<sup>229</sup> This change includes most

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<sup>224</sup> Veron, N. (2010). An Update on EU Financial Reforms (Policy Brief No. PB10-30). Retrieved from Peterson Institute for International Economics website: <http://www.iie.com/publications/pb/pb10-30.pdf> : 2

<sup>225</sup> Peston, R. (2011 17-February). *The FPC: Running the Financial Economy*. Retrieved 2011 11-April from BBC.com: [http://www.bbc.co.uk/blogs/thereporters/robertpeston/2011/02/the\\_fpc\\_running\\_the\\_financial.html](http://www.bbc.co.uk/blogs/thereporters/robertpeston/2011/02/the_fpc_running_the_financial.html)

<sup>226</sup> Ibid.

<sup>227</sup> Peck (2011)

<sup>228</sup> Bailey, A. (2011 17-March). *Speech: Financial Stability- Objective and Resolution*. Retrieved 2011 18-April from Bank of England: [www.bankofengland.co.uk/publications/speeches](http://www.bankofengland.co.uk/publications/speeches)

<sup>229</sup> Chambers, C. (2010). Banking on Reform in 2010: is Regulatory Change Ever Enough and Will the General Election Hold the Answers for the Financial Services Industry. *The Law Teacher*, 44 (2), pp. 218-234: 224

prominently allowing for banks to fail and accepting the cyclical nature of the economic system.<sup>230</sup> As a result of these revisions the UK entered a ‘knee-jerk’ reaction to the GFC and was forced to undergo several consequent reforms, including the Turner Review, the White Paper on Financial Reform and the Walker Review.<sup>231</sup>

### **5.2.3.5 Germany**

#### *Supervisory Authorities*

BaFin and The Deutsche Bundesbank (collectively, the Supervisory Authorities) jointly supervise banks amongst other financial institutions; BaFin focuses mainly on solvency and market supervision whereas the Bundesbank is responsible for the ongoing monitoring process.<sup>232</sup>

#### *KWG*

With regards to legislation, German bankers have to conform to two acts. The German Banking Act (KWG) stipulates the fundamental regulatory provisions regarding the conduct of business of banks, now (after the GFC) particularly with the intent of dealing with troubled systemic important institutions.<sup>233</sup> The Payment Services Regulation Act (ZAG), the second of these legislative documents sets Germany’s capital requirement demands.

Following the crisis, Germany has been intent on restructuring the balance of power in its banking sector. This mostly refers to the influence of corporate sectors as mentioned. In addition Germany aims to overhaul the country’s existing supervisory institution. As part of this overhaul, the process of relocating banking supervision to the German Central Bank has been started, but not concluded as of yet. Thus far, a coalition agreement has proposed this relocation from the hands of BaFin, but this proposal has yet to be legislated.<sup>234</sup> The practice of supervision will nevertheless retain a similar model to that brought in through reforms of the early 2000s, in that supervision is collected under the auspices of one institutional body.<sup>235</sup>

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<sup>230</sup> Ibid.: 224

<sup>231</sup> Ibid.: 224

<sup>232</sup> Gluck, O., Kramer, R., Eschenlohr, D., Wintzer, S., & Bernau, T. P. (2011). Germany. In D. E. Shapiro (Ed.), *Banking Regulation in 27 Jurisdictions Worldwide* (pp. 20-27). London, UK: Getting the Deal Through: 21

<sup>233</sup> Ibid.: 20

<sup>234</sup> Linklaters (2011): 93.

<sup>235</sup> Moora, M. (2010). Global Crisis and Financial Regulations: Who Determines What? Cross-Country Analysis of China, Germany, Japan, UK, and USA. *Colonial Academic Alliance Undergraduate Research Journal*, 1 (1).

### ***5.2.3.6 Findings***

The above discussion of legislation and regulatory bodies is important because these represent the existing frameworks that will channel and is channelling the reform. It was noted earlier that this study does not argue that the implementation of this reform is path dependent, and this is not the intent of this section. Where the reformed legislation and regulatory bodies show responses to the regulatory demands of each country, the lack of reform is equally important in reflecting policy interests.

Two countries, the US and the UK have taken it on themselves to implement significant reforms; the US with the gargantuan DFA and the UK with the new FPC and its several reform reviews. Canada on the other hand has been content with a minor review of its primary legislation, indicating its preference for the status quo. There have been major reforms to the EU structure and the slow speed of reforms in Germany confirms other evidence that it is relying on these EU reforms to provide the necessary changes. Both EU members are furthermore looking to return the mandate to supervise to their central banks. Arguably the UK's reforms, in terms of the degree of political involvement, have brought it closer to the EU model and it is possible that this signifies a regional convergence. It is also noticeable that all the four cases have pursued individual interests in their actions.

### **5.2.4 Requirements and standards**

The following breakdown of some of the more specific facets of banking regulation is a response to the more frequently mentioned topics in the discussion of global banking. Two of these are continuations of contentious issues from previous rounds of discussion, that is capital requirements and credit rating, whilst the two remaining, leverage and liquidity, have become bigger issues due to post crisis discoveries. There are other regulatory issues that could be discussed, but these are the ones that have dominated the spotlight in international discussions, particularly those at the BCBS.

#### ***5.2.4.1 Capital Requirements***

One of the biggest concerns of the Basel discussions dealt with the level of capital requirements a bank needs to uphold to reflect the risks of both the market and the specific investment choices of that institution. Simply put, capital requirements stipulate the minimum ratio between regulatory capital and total risk weighted assets (capital ratio) an institution is allowed. This means that

requirements are also sensitive to how capital is defined. Capital is normally categorized into 3 tiers. Defining these tiers is a different matter altogether, as the different banking systems' structures results in specific requirements of different persuasions.

The standardization of definition therefore makes up a heated discussion between countries. The problem of capital definition is bigger in Europe, where the debated types of capital feature more prominently on banks balance sheets.<sup>236</sup> In fact, neither has there been a unilateral nor a collaborated EU move to push actively for a new Basel agreement on capital adequacy.<sup>237</sup> As opposed to the US, both the UK and Germany have been aligned in their opposition to new capital definitions that exclude hybrid capital from the tier 1 (the most important to risk management) tranche.<sup>238</sup>

It is natural that capital requirements have become a central discussion, as capital requirements have been pivotal to the BCBS in other rounds also. Thus far there seems to be general support for the capital requirement recommendations of Basel III between the cases discussed here. The important factor to notice is how each country expects to implement new standards through pre-existing frameworks that will likely influence the form this takes. Therefore the purpose behind the following accounts is not necessarily to highlight the specific ratios, but rather the divergence in intended method for adapting capital requirements. Two of the more notable cases are Germany and the US, where the banking sector is divided into different categories that define the requirements for capital.

#### *5.2.4.1.1 The US*

In monitoring capital requirements, the DFA divides US banks into those that are well capitalized and those that are adequately capitalized. Based on prior standards, the DFA's Collins Amendment demands a Tier 1 risk based capital ratio of 6% for well-capitalized institutions and 4% for those that are adequately capitalized. This amounts to a total risk based capital ratio (all tiers included) of 10% for well-capitalized and 8% for adequately capitalized banks.<sup>239</sup>

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<sup>236</sup> Atlantic Council (2010): 19

<sup>237</sup> Buckley and Howarth (2010): 133

<sup>238</sup> Ibid.: 135

<sup>239</sup> Acharya Kulkarni and Richardson (2011): 154

One important aspect of the Collins Amendment is that it includes a provision for excluding hybrid securities from Tier 1 capital.<sup>240</sup> In addition, the Fed has proposed to issue separate rules for foreign-based institutions to which the US plays host.<sup>241</sup> Lastly, the DFA differs from Basel in that it distinguishes between large and small banks in its implementation schedule; larger banks are given less time to phase out hybrid securities, or lesser forms of capital, from their Tier 1 base than smaller ones.<sup>242</sup>

In addition to setting requirements for Tier 1 capital, the DFA opens for the possibility of allowing contingent capital as an additional form of capital for Systemically Important Financial Institutions (SIFI).<sup>243</sup> This category, which includes CoCo bonds, is a form of uninsured debt that converts into equity upon the achievement of certain pre-specified triggers.<sup>244</sup> The importance of this relates to the uncertainty surrounding this untraditional form of capital and a global reluctance to accept it. A decision on this possibility will follow a recommendation of an expected report.

#### 5.2.4.1.2 Canada

Capital regulation in Canada is based on two focal points: both minimum risk-based capital ratio (as in the Basel agreements) and maximum assets-to-capital multiple restrictions.<sup>245</sup> Although capital requirements are based on Basel, Canadian minimum thresholds have traditionally been set higher (compared to Basel II), at 7 percent for Tier 1 capital and 10 percent for total capital.<sup>246</sup> In addition, the assets-to-capital multiple, which denotes that banks total assets cannot be more than a certain multiple of their total capital, is restricted to a maximum multiple of 20.<sup>247</sup> Current developments include an aim to incorporate the new Basel requirements for capital into this

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<sup>240</sup> H.R. 4173--111th Congress: Dodd-Frank Wall Street Reform and Consumer Protection Act. (2009). In GovTrack.us (database of federal legislation). Retrieved February 29, 2012, from <http://www.govtrack.us/congress/bills/111/hr4173>: Sec. 174

<sup>241</sup> Nasiripour, S. (2011 21-December). *Fed Proposes New Bank Rules to Tackle Financial Threats*. Retrieved 2012 5-January from Financial Times: <http://search.proquest.com/docview/912203675?accountid=12870>

<sup>242</sup> Eubanks (2010): 11

<sup>243</sup> Acharya, Kulkarni and Richardson (2011): 165

<sup>244</sup> *Ibid.*: 162

<sup>245</sup> Lebond (2011): 11

<sup>246</sup> *Ibid.*

<sup>247</sup> *Ibid.*

system, with Canadian interpretations of the standards being processed through the normal course of action within OSFI.<sup>248</sup>

#### 5.2.4.1.3 The EU

The collective policies of the CRD basically reflect the standards set through Basel. As the most recent amendments to the Accord have yet to be phased in, the policies are accordingly still to be synchronized. The last formal changes made to the CRD (CRD III) do however take into account the new standards for capital requirements and these are currently pressuring European banks to accumulate capital.<sup>249</sup> The upcoming fourth directive mirrors the requirements of Basel III, but gives a comparably detailed definition of common equity (the main aspect of Tier 1 capital). One concern regarding this is that these definitions diverge from Basel III.<sup>250</sup>

Within the EU, the emphasis has been placed on securitization and re-securitization, as well as classifying ‘hybrid capital’, a contentious issue particularly for Germany.<sup>251</sup> The proposal recommends a common equity Tier 1 ratio of 4.5% and a total capital ratio of 8% that is comparable to the recommendations of Basel.<sup>252</sup> However, in attempting to stem the recent banking crisis, EU finance ministers have shown a willingness to increase these numbers. Through the recapitalization plan they have demanded that banks achieve a temporary 9% Tier 1 buffer by June 2012, two years earlier than the 6% aim of Basel for 2014.<sup>253</sup> If these aims are upheld it shows that the EU can act decisively in changing its financial parameter, without regards to Basel’s minimum requirements.

The proposal has been met with contention on one particular point regarding harmonization of the European market. This legal element (article 5.1 of the CRD) becomes particularly problematic combined with article 87 on capital requirements. Essentially the principle restrains national authorities from imposing individual higher minimum capital requirements than those of

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<sup>248</sup> OSFI. (2011, February 1). *Basel III Implementation: Capital Adequacy and Liquidity Requirements*. Retrieved February 6, 2012 from OSFI: [http://www.osfi-bsif.gc.ca/app/DocRepository/1/eng/guidelines/capital/advisories/cptlq\\_e.pdf](http://www.osfi-bsif.gc.ca/app/DocRepository/1/eng/guidelines/capital/advisories/cptlq_e.pdf): 1

<sup>249</sup> The Economist. (2011 9-April). European Banks: Topping Up. *The Economist*.

<sup>250</sup> Veron (2012):16

<sup>251</sup> Stichele, M. V. (2009 September). *An Oversight of Selected Financial Reforms on the EU Agenda*.. Retrieved 2011 12-November from SOMO: [http://somo.nl/publications-en/Publication\\_3221](http://somo.nl/publications-en/Publication_3221)

<sup>252</sup> Directive of the European Parliament and the Council on the Access to the Activity of Credit Institutions and Investment Firms and Amending Directive 2002/87/EC of the European Parliament and of the Council on the Supplementary Supervision of Credit Institutions, Insurance Undertakings and Investment Firms in a Financial Conglomerate. (CRD IV) (2011). In European Commission Archives. Retrieved October 10, 2011, from [http://ec.europa.eu/internal\\_market/bank/docs/regcapital/CRD4\\_reform/20110720\\_directive\\_proposal\\_en.pdf](http://ec.europa.eu/internal_market/bank/docs/regcapital/CRD4_reform/20110720_directive_proposal_en.pdf): Article 87

<sup>253</sup> Lannoo, K. (2012 30-January). *Europe Needs to Flex its Muscles with Banks*. Retrieved 2012 8-February from Financial Times: <http://www.ft.com/cms/s/0/02c7968a-41c3-11e1-a586-00144feab49a.html>



CRD IV.<sup>254</sup> This is particularly difficult with the UK, which has aimed at setting higher standards.

As a last note, it should be pointed out that the CRD IV regulation proposal allows for CoCo bonds as Additional Tier 1 capital (AT1). This happens upon the trigger condition that the Tier 1 capital ratio of an institution falls below 5.125%.<sup>255</sup> In this sense, the European regulation is one step ahead of US developments.

#### 5.2.4.1.4 *The UK*

With regards to capital requirements, British interim minimum ratios are higher than what Basel, and subsequently the CRD demands.<sup>256</sup> British regulators have inquired into continuing this trend. For example, in its conclusion the Independent Banking Commission advised chancellor Osborne on the inadequacy of the Basel III capital requirements.<sup>257</sup> The same commission has recently recommended a British requirement of 10 percent of core Tier 1 capital; substantially more than what Basel recommends.<sup>258</sup> Furthermore, there seems to be a silent support amongst even City investors for maverick prudence in Britain.<sup>259</sup>

In addition to recommending increased prudence, British regulators have also introduced extraordinary legislation through the freedom given by interpretive liberties in the current EU directive (in waiting for CRD IV). The UK strictly defines standards for capital instruments, determinants of bank specific requirements, as well as other technical details that the Banking sector fears puts it at a disadvantage.<sup>260</sup> This marks an unprecedented degree of regulatory involvement for London.

British capital requirements are outlined in the GENPRU sourcebook given by the FSA. This document provides a great extent of variations for different categories of financial institutions and by doing so provides more specific standards than the other examples. Furthermore, British

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<sup>254</sup> CRD IV (2011): article 87

<sup>255</sup> CRD IV (2011): Article 51

<sup>256</sup> Freshfields Bruckhaus Deringer LLP. (2011 25-january). *UK Banking Regulation: Level Playing Field Issues*. Retrieved 2011 15-April from British Banker's Association: <http://www.bba.org.uk/publications>

<sup>257</sup> Peston (2011a)

<sup>258</sup> Guerrero, F. (2011 11-April). *Proposals Bring UK Industry Closer to US Rules*. Retrieved 2011 17-April from FT.com: [www.ft.com/cms/s/0/fe2134a4-6484-11e0-a69a-00144feab49a.html](http://www.ft.com/cms/s/0/fe2134a4-6484-11e0-a69a-00144feab49a.html)

<sup>259</sup> Jenkins, M. S., & Parker, G. (2011 12-April). *City Investor Chiefs Back Banking Revamp*. Retrieved 2011 16-April from FT.com: [www.ft.com/cms/s/0/d75eeb90-6547-11e0-b150-00144feab49a.html](http://www.ft.com/cms/s/0/d75eeb90-6547-11e0-b150-00144feab49a.html)

<sup>260</sup> Freshfields Bruckhaus Deringer LLP (2011): 2.

guidelines for tier 1 capital definitions rely on noticeably different terms compared with the legislation of both Canada and the US (as the two other English speaking examples). Although the different terms refer to similar concepts, it is likely that they carry connotations that cause deviation in the interpretations.

#### 5.2.4.1.5 Germany

The KWG states that banks must maintain an adequate liquidity for payment purposes at all times as well as appropriate capital and adequate funds.<sup>261</sup> The required standards are built on those of CRD II and CRD III as implemented into German law. If all goes according to procedure, they are expected to be upgraded to the standards of Basel III as it is processed through the EU structure.<sup>262</sup> However one important difference remains. Germany stands out in its definition of capital by segmenting its guidelines to reflect the three different types of banks seen in its financial sector. This means that although the German Tier 1 requirements appear similar to the ones found in the other cases, they offer definitions more specifically tailored to the German market, something that allows for different interpretations deviating from international norms.

It should be noted that although it is built on the CRD, German regulation does already require capital reserves above what CRD II recommends.<sup>263</sup> The process of further upgrading capital requirements has been delayed in Germany due to the nature of the German economy, which is as mentioned centred on banks rather than financial institutions like those of London's capital market. This delay has particularly been caused by the attempt to define Tier 1 capital, where German banks are trying to defend the use of 'hybrid capital', but also in the negotiation of the time framework for implementing the new directives.<sup>264</sup> Interestingly, Germany has lobbied for the loosening of EU capital rules, apparently to avoid the revelation of bad loans that plague its banking system.<sup>265</sup> Lobbying in this way has undermined the faith in Germany's own requirements and generated the impression that Berlin is reluctant to enforce the necessary measures on its own banks.<sup>266</sup>

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<sup>261</sup> Gluck, O. et al. (2011): 24

<sup>262</sup> Ibid.

<sup>263</sup> Hardie and Howarth (2009): 1033.

<sup>264</sup> Onaran, Y. (2010 27-July). *Basel Committee Softens Bank Capital Rules, Sets Leverage Cap*. Retrieved 2011 April from Bloomberg: <http://www.businessweek.com/news/2010-07-26/basel-committee-softens-bank-capital-rules-sets-leverage-cap.html>

<sup>265</sup> Buckley and Howarth (2010): 135

<sup>266</sup> Ibid.

#### 5.2.4.2 Leverage Ratio

One of the findings following the GFC was the discovery of astonishingly high leverage ratios of some financial institutions. Simply put, leverage measures the size of ‘bet’ on every dollar of a firm’s capital by pointing out the ratio between assets to equity. Monitoring leverage has become pertinent as a result of this discovery in the symptoms of the crisis. For example, the lead-up to the crisis saw the leverage ratio of some of the US’s most troublesome institutions increase manifold, in one case climbing from 20:1 to 40:1 in five years.<sup>267</sup> Whilst operable in pre-crisis times, excessive leverage became a problem once lending cycles were broken and borrowers were coming up empty in their repayments. It has since become noted that capital requirements need to be augmented by restrictions on leverage ratios.

The reception of this proposition has diverged between the different countries. It is therefore likely that the implementation of leverage standards will be contested in some cases, particularly in Europe where the problem of overleveraging has been rampant. In this section it is important to note that both Canada and the US have the necessary tools for monitoring leverage already in place, whereas these have not been prioritized previously in Europe. Furthermore, there seems to be a split in the position of Germany and the UK regarding this requirement. This indicates a divergence in policy interests and contents.

##### 5.2.4.2.1 *The US*

Although the US was among few countries that imposed restrictions on leveraging prior to the crisis, its regulatory blind eye to shadow banking allowed institutions to nevertheless circumnavigate these restrictions. Now, through the DFA however, Leverage ratio requirements are legislatively equivalent with capital requirements and are an important tool for the restructuring of US regulation. Rather than set a minimum requirement, the Act leaves the decision up to the ‘appropriate agency’ only requiring that the minimum does not drop below those in existence prior to the implementation of the Act.<sup>268</sup> The categorical separation of banks

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<sup>267</sup> Lewis, M. (2010). *The Big Short*. New York, NY, United States: W.Norton & Company.159

<sup>268</sup> Dodd-Frank Wall Street Reform and Consumer Protection Act. (2009): Sec. 171 b) 1

in terms of size is recurrent for these standards also. The current floor demands leverage ratios of 5% for well-capitalized banks and 4% for adequately capitalized ones.<sup>269</sup>

#### 5.2.4.2.2 Canada

The aforementioned assets-to-capital multiple (ACM) is in effect Canada's leverage ratio. The legislation insists on a maximum multiple of 20 times total capital, which corresponds to a leverage ratio of 5 percent (as compared to Basel's 3 percent).<sup>270</sup> It should be noted that Canada was the only country in this study besides the US to impose such a constraint on its banks prior to the crisis. Nevertheless, Canada is unique in requiring all of a financial group's activities to be included in the calculation of this multiple,<sup>271</sup> and as such is the most complete example of supervised leverage in this analysis. The complete definition of leverage has been transferred to the new Basel standard, one instance where Canada has managed to act as a leader.<sup>272</sup>

The strict supervision of leverage prevented the exploitation of regulatory loopholes in the Canadian financial system and the subsequent development of a shadow-banking sector as in the case of the US.<sup>273</sup> Currently OSFI is considering the effects of Basel III's leverage ratio. The superintendent expects to interpret the ratio within the ACM system already in place.<sup>274</sup>

#### 5.2.4.2.3 The EU<sup>275</sup>

Prior to the crisis leverage was only lightly constrained by EU authorities.<sup>276</sup> As a result, overleveraging has become a major issue for European financial institutions. Jacopo Carmassi claims that mitigation techniques encouraged by previous Basel capital rules are the primary reason for EU leverage problems.<sup>277</sup> Perhaps the biggest problem was the lack of an effective ceiling on leverage, a major regulatory weakness identified in hindsight.<sup>278</sup> Despite this, the EU has not taken any prominent steps to address this issue. In fact, some EU members have fears that

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<sup>269</sup> Acharya, Kulkarni and Richardson (2011): 154

<sup>270</sup> Leblond (2010-2011): 12

<sup>271</sup> Ibid.

<sup>272</sup> Leblond (2011): 70

<sup>273</sup> As the ability to leverage in the shadow sector through subsidiaries allowed institutions to remain stable in the limited scope of US regulators.

See Leblond (2010-2011): 12

<sup>274</sup> OSFI (2011): 2

<sup>275</sup> Information taken from: Linklaters (2011)

<sup>276</sup> Leblond (2010-2011): 15

<sup>277</sup> Carmassi, J, Gros, D., & Micossi, S. (2009). The Global Financial Crisis: Causes and Cures. *Journal of Common Market Studies*, 47 (5), pp. 977-996.

<sup>278</sup> Leblond (2010-2011): 15.

new leverage standards will cause significant economic harm.<sup>279</sup> At the current stage, CRD IV is due to implement a requirement that institutions calculate leverage ratios, but unlike Basel III it does not relate these to a minimum standard.<sup>280</sup> Leverage ratios have actually increased in the Union following the crisis.

#### 5.2.4.2.4 *The UK*

Amidst plans to implement European minimum standards, the UK is planning to enforce its banks to publicize their leverage ratios in 2013, which is two years before the planned implementation of similar measures by both Basel and the EU.<sup>281</sup> Rather than political prudence, this seems to be a response to growing market concern on banks' honesty regarding Tier 1 capital ratios.<sup>282</sup> This move appears to be the major independent decision by UK authorities, and a clear contrast to its European counterpart, Germany.

#### 5.2.4.2.5 *Germany*

German bankers have, through the Association of German Banks (BDB), taken an adamant stance against any form of leverage cap.<sup>283</sup> Bundesbank president Axel Weber on the other hand has praised Basel's insistence on including the concept in its new proposals.<sup>284</sup> Leverage is an important term of disagreement between the authorities and the powerful banking sector. Germany is expected to conform to CRD IV leverage requirements, and as a result, German banks have been vehement in voicing its concern over these.<sup>285</sup> It is still too early to say how Germany will handle this situation in any specific detail.

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<sup>279</sup> Atlantic Council (2010): 19

<sup>280</sup> Association for Financial Markets in Europe. (2011, November 2). *Briefing Note: CRD IV- Leverage*. Retrieved February 2, 2012 from AFME: [www.afme.eu/WorkArea/DownloadAsset.aspx?id=5669](http://www.afme.eu/WorkArea/DownloadAsset.aspx?id=5669)

<sup>281</sup> Masters, B. (2011 1-December). *Banks Told to Reveal Leverage Early*. Retrieved 2012 7-February from Financial Times: <http://www.ft.com/cms/s/0/5d752962-1c20-11e1-af09-00144feabdc0.html>

<sup>282</sup> *Ibid.*

<sup>283</sup> Jones, H. (2010 5-March). *German Banks Take Aim at Basel III Leverage Cap*. Retrieved 2012 8-February from Reuters: [www.reuters.com/assets/print?aid=USLDE6241UZ20100305](http://www.reuters.com/assets/print?aid=USLDE6241UZ20100305)

<sup>284</sup> Jaidev, R. (2010 1-October). *Weber, Blankfein Praise Basel III Leverage Cap*. Retrieved 2012 8-February from Central Banking: [centralbanking.com/central-banking/news/1736811/weber-blankfein-praise-basel-iii-leverage-cap](http://centralbanking.com/central-banking/news/1736811/weber-blankfein-praise-basel-iii-leverage-cap)

<sup>285</sup> Barker, A. (2012 22-January). *Paris and Berlin Seek to Dilute Bank Rules*. Retrieved 2012 8-February from Financial Times: <http://www.ft.com/cms/s/0/7f8485a8-4500-11e1-a719-00144feabdc0.html>

### 5.2.4.3 Liquidity

Liquidity, or the capacity of a banking institution to generate currency in time to meet its commitments, is referred to as the Gordian knot of the financial crisis.<sup>286</sup> The BCBS defines it as the ‘ability of a bank to fund increases in assets and meet obligations as they come due, without incurring unacceptable losses.’<sup>287</sup> It has indeed evolved into a highly complicated problem for finance ministers, particularly in the Eurozone. This problem is mirrored in the concerns of regulators, where there is a growing fear that individual answers to financial governance will lead to increased liquidity problems.<sup>288</sup> The regulation of liquidity refers to not only the requirements directed to ratio of liquid assets, but also what assets are to be considered liquid.

The different country cases show that liquidity requirements have been handled on an individual basis so far. Both the UK and Germany have codified new laws, but done so autonomous of EU coordination. Despite there being consensus on the necessity of liquidity requirements, countries seem eager to diverge in the implementation of this instrument.

#### 5.2.4.3.1 The US

The DFA is rather vague on liquidity requirements, but it is assumed that regulators will look to Basel III for the specifics.<sup>289</sup> The stated intention by the Fed is to rely on banks’ own internal modelling to find liquidity needs. Together with the inclusion of GSE securities in the category of ‘highly liquid assets’ this is viewed as an important victory for the banking industry.<sup>290</sup> The opaque stand on liquidity is one of the indicators that the DFA simply perpetuates *laissez-faire* policies.

#### 5.2.4.3.2 Canada

As mentioned, the primary response to the crisis in Canada was an intervention in the short-term lending market by the Federal government. In other words, the intervention was to provide

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<sup>286</sup> Blancheton, B., Bordes, C., Maveyraud, S., & Rous, P. (2011). Risk of Liquidity and Contagion of the Crisis on the United States, United Kingdom and Euro Zone Money Markets. *International Journal of Finance and Economics*, 17 (2), pp. 124-146.

<sup>287</sup> Porter (2010): 57

<sup>288</sup> Bernanke, B. S. (2012, February 13). *Joint Notice of Proposed Rulemaking Implementing the Volcker Rule: Federal Reserve Docket No. R-1432 and RIN-7100 AD 82; OCC Docket ID OCC-2011-0014; FDIC RIN 3064-AD85; SEC File No. S7-41-11 CFTC RIN 3038-AC*. Retrieved February 27, 2012 from SEC.gov: <http://www.sec.gov/comments/s7-41-11/s74111-211.pdf>

<sup>289</sup> Acharya, Kulkarni and Richardson (2011): 159

<sup>290</sup> Nasiripour (2011)

liquidity to improve credit conditions.<sup>291</sup> Liquidity constraint was thus a big concern for the Canadian authorities following the GFC.<sup>292</sup> Nevertheless, no new liquidity standards have been introduced as a result. The superintendent stipulates that banks establish vaguely defined ‘sound’ and ‘prudent’ liquidity policies recommended and approved internally.<sup>293</sup> These guidelines are expected to be upgraded to comply with the international rules for bank liquidity of Basel III. So far, however, the OSFI has shown caution in acceding to the Basel recommendations, waiting on extensive testing prior to their implementations.<sup>294</sup>

#### 5.2.4.3.3 *The EU*<sup>295</sup>

The Basel recommendations concerning liquidity are being reviewed in the current rounds of consultations for CRD IV. The proposals thus far resemble the standards set by the Basel committee in that they require the two new ratios as well as the four proposed monitoring tools that have been recommended. The EU proposals do distinguish themselves in that they table suggestions for more universal supervision (including both parent and subsidiary financial institutions and also investment firms dealing with their own accounts), and are as such stricter than the Basel recommendations.

However, there has been a resistance towards the development of tighter EU level liquidity restrictions. As a result, both the UK and Germany seem to have followed their own paths towards regulating liquidity at this stage in their regulatory response.<sup>296</sup>

#### 5.2.4.3.4 *The UK*

The reformed UK policy path can particularly be seen within the category of liquidity. Rather uncharacteristic to the British paradigm, the UK was quick to implement a set of liquidity rules including a liquidity adequacy rule, liquidity assessment standards, and a liquidity buffer system

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<sup>291</sup> Zorn et al. (2009): 4

<sup>292</sup> Bank of Canada. (2009, December). *Financial Systems Review: December 2009*. Retrieved February 2, 2012 from Bank of Canada: [http://www.bankofcanada.ca/wp-content/uploads/2010/04/fsr\\_1209.pdf](http://www.bankofcanada.ca/wp-content/uploads/2010/04/fsr_1209.pdf): 4

<sup>293</sup> Liquidity Guideline B-6 as commented on by Hyman et al. (2011): 94

<sup>294</sup> OSFI (2011)

<sup>295</sup> Information taken from: Linklaters (2011)

<sup>296</sup> Buckley and Howarth (2010): 135

appropriate to the risk profile and activities of individual institutions.<sup>297</sup> These rules essentially match the global efforts that other countries have been reserved against implementing.<sup>298</sup>

Although earlier developments pointed to a return to normal, with regulators considering diluting the measures,<sup>299</sup> banking sector lobbying was not successful in turning over the increased liquidity stringency. At the discussion through ‘Project Merlin’, banks argued that the British legislation puts them at a disadvantage internationally- an argument that gained sympathy with exchequer chancellor Osborne.<sup>300</sup> Nevertheless, Britain’s stance has held and even proved beneficial to British banks, many of which are now privately relieved the authorities proved so resilient.<sup>301</sup>

#### 5.2.4.3.5 Germany

Germany has implemented liquidity requirements through its MaRisk act pre-emptively to the implementation of CRD recommendations. These requirements are tailored to individual banks based on size, complexity, and circumstance.<sup>302</sup> MaRisk has since the third round of Basel been revised to include liquidity buffers and other points of importance from the accord.<sup>303</sup> The German interpretation of the European guidelines has been to limit the new requirements to capital-market oriented institutions.<sup>304</sup>

#### 5.2.4.4 Regulating Credit Rating

The rating of credit is central to determining the stability of banks. In a discussion of the BCBS’s analysis of the regulatory uses of credit ratings, Amadou Sy concludes that credit ratings are an ‘essential part of the regulatory process for identifying assets that are eligible for investment purposes, for determining capital requirements and for providing an evaluation of credit risk.’<sup>305</sup> Higher rated bonds and securities are given special status with respect to capital requirements,

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<sup>297</sup> Linklaters (2011).

<sup>298</sup> Masters (2011a)

<sup>299</sup> See for example Pratley, N. (2011 17-February). *Surely Bank Liquidity Rules Aren't Being Diluted Already*. Retrieved 2011 14-April from Guardian.co.uk: <http://www.guardian.co.uk/business/2011/feb/17/bank-liquidity-being-diluted/print>

<sup>300</sup> Parker, G., & Masters, B. (2011 16-February). *Osborne Eyes Looser Liquidity Regime*. Retrieved 2011 14-April from FT.com: [cache.ft.com/cms/s/0/39cf744a-3a17-11e0-a441-00144feabdc0.html](http://cache.ft.com/cms/s/0/39cf744a-3a17-11e0-a441-00144feabdc0.html)

<sup>301</sup> Masters (2011a)

<sup>302</sup> KPMG. (2009 November). *Evolving Banking Regulation: Overview and Impact Assessment*. Retrieved 2011 11-April from KPMG: <http://www.kpmg.com/Ca/en/IssuesAndInsights/ArticlesPublications/Pages/EvolvingBankingRegulationOverviewandImpactassessment.aspx>

<sup>303</sup> Hofer, M. (2010 15-April). MaRisk: Further Revision to Take Account of International Standards. *BaFin Quarterly* .

<sup>304</sup> Ibid.

<sup>305</sup> Sy, in Altman, E. I., Oncu, S., Richardson, M., Schmeits, A., & White, L. J. (2011). Regulating of Rating Agencies. I V. V. Acharya, et al. (2011): 446



and are less demanding for financial institutions to hold. For example, in the US prior to the crisis, zero capital requirements were needed for an AAA rated security if an AAA rated insurance company provided credit enhancement for it.<sup>306</sup> Government reliance upon credit rating as a method of supervision makes it crucial to the regulation of banks.

One aspect that adds a bias to this method is governments' dependence on credit rating agencies (CRAs) in providing the necessary ratings. This is due to the circumstance that the most influential agencies are located in the US. This gives the US market a clear advantage and could possibly put pressure on other countries' legislators to converge with the US model. To find divergence in this category we would look for states to attempt to secure their independence from standard reliance on CRAs.

#### 5.2.4.4.1 *The US*

US regulation relies on CRAs; since the 1930s, CRAs have been placed as the central source of information about the creditworthiness of bonds in US financial markets.<sup>307</sup> This policy was institutionalized through the establishment of the Nationally Recognized Statistical Rating Organization (NRSRO), which gave special roles to a few designated rating agencies.<sup>308</sup> These agencies worked according to an 'solicited rating' business model, where the issuer of securities both chooses and pays the rating agency for its services allowing it to 'shop around' for the best possible rating.<sup>309</sup> It has been widely argued that this conflict of interest and overall reliance on a few designated agencies played a central role in catalyzing the financial crisis.<sup>310</sup>

The DFA goes to measures to corral this problem by mentioning new improved internal controls and rating accuracy standards for agencies as well as removing the regulatory reliance on ratings.<sup>311</sup> Compared to the path of the EU and Canada, these new measures emphasize transparency as their main focus.<sup>312</sup> However, according to Altman and his colleagues, the Act is less forceful in removing the problem of 'incentive misalignment in the solicited rating model'

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<sup>306</sup> Altman et al. (2011): 447

<sup>307</sup> Ibid. 444

<sup>308</sup> Ibid. 446

<sup>309</sup> Mollers, T. M. (2009). Regulating Credit Rating Agencies: the New US and EU Law- Important Steps or Much Ado About Nothing? *Capital Markets Law Journal*, 4 (4), pp. 477-500: 5

<sup>310</sup> Altman et al. (2011): 443

<sup>311</sup> Ibid.: 444

<sup>312</sup> Rousseau (2009): 31

(although it does prohibit CRAs from making recommendations to the issuer it is rating).<sup>313</sup> Overall, the reforms of the DFA does not include a change of policy in terms of risk measurement, but remains reliant on the calculation of default risk by rating agencies. This perpetuates one of the determining factors of the GFC, namely the regulatory focus on individual bank risk rather than a consideration of overall systemic risk.<sup>314</sup>

#### *5.2.4.4.2 Canada*

Canadian regulation only recognizes ratings issued by ‘approved’ or ‘recognized’ rating agencies, a rather limiting category with few alternatives. Agencies are defined as approved or recognized through a rudimentary listing of the larger CRAs.<sup>315</sup> Institutions that receive permission may also follow the Internal Ratings Based Approach (IRB) and supervise their own credit rating. Thus far in the reform process, decision makers in the Canadian Securities Administration (CSA) are analyzing whether to look to the approach taken by the US in deciding whether to maintain, modify or delete references to CRAs in Canadian legislation.<sup>316</sup>

The proposal that has been amassed through this process emphasizes disclosure and transparency. This ‘disclosure based model’ relies on the public disclosure of all information provided by an institution seeking a credit rating for an asset-backed security.<sup>317</sup> In principle, such disclosure would enable other CRAs to issue ‘unsolicited ratings’ for which to counterbalance the incentive for agencies to sell favourable ratings to attract business (discussed further in the US section.)<sup>318</sup> A final point that the CSA emphasize is that the disclosure-based approach would provide a framework that fosters compliance with the IOSCO code of conduct.<sup>319</sup>

#### *5.2.4.4.3 The EU*

Although the reliance on credit rating is quite similar within the EU as it is in the US, the EU has been remarkably opaque in its regulation. Before the crisis, the EU relied upon self-regulation

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<sup>313</sup> Altman et al. (2011): 444

<sup>314</sup> Acharya, Kulkarni and Richardson (2011): 153

<sup>315</sup> Rousseau (2009): 17

<sup>316</sup> Ibid.: 36

<sup>317</sup> Ibid.: 33

<sup>318</sup> Ibid.

<sup>319</sup> Ibid.: 54

within the framework of the IOSCO Code.<sup>320</sup> In recent developments however, the CRD has been relatively direct in its requirements for credit assessment as compared to Basel's proposals.<sup>321</sup> Recent developments have shown a remarkable shift in the European policy direction. The new focus seems to be quite rigorous state regulation of CRAs.<sup>322</sup> Indeed there seems to have been significant progress at the EU level in regulating agencies, possibly because restricting their operations is less sensitive for the national governments of EU members.<sup>323</sup> As a result, CRAs were moved under a single regulatory regime early on in the crisis response process.<sup>324</sup>

Similar to the US, new regulation dealing with the conflict of interest problem (solicited rating) prohibits a CRA from providing consultation or advisory services to an entity it is also providing ratings for.<sup>325</sup> It should also be noted that EU legislation is more precise than that of the US,<sup>326</sup> and the EU is attempting to alleviate its regulation's reliance on rating agencies.<sup>327</sup> In these ways, the EU proposal for the regulation of CRAs goes further than any other country's equivalent.<sup>328</sup>

#### 5.2.4.4.4 *The UK*

In determining credit risk, UK banks have a choice between a standardized approach with pre-set categories, and advanced approaches where internal models are an option.<sup>329</sup> The 2009 Turner Review, which set out the proposals of the FSA, also covered CRAs. The proposals relevant to credit rating suggested a decreased reliance on agencies, urging that ratings only be used for the purposes to which they were suited.<sup>330</sup> As the same review pointed to CRAs role in sharing responsibility for the GFC,<sup>331</sup> it is not surprising that the UK also takes a regulatory step away from relying on such agencies.

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<sup>320</sup> Utzig, S. (2010). *The Financial Crisis and the Regulation of Credit Rating Agencies: a European Banking Perspective* (Working Paper No. 188). Retrieved from: <http://ssrn.com/abstract=1592834>: 8

<sup>321</sup> Amtenbrink, F., & De Haan, J. (2009 18-June). *Regulating Credit Rating Agencies in the European Union: a Critical First Assessment of the European Commission Proposal*. Retrieved 2012 7-February from Fourth International Conference on Financial Regulation and Supervision: [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=13943324](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=13943324)

<sup>322</sup> Utzig (2010): abstract

<sup>323</sup> Buckley and Howarth (2010): 132

<sup>324</sup> Ibid.: 132

<sup>325</sup> Moellers (2009): 8

<sup>326</sup> Ibid.

<sup>327</sup> Lannoo (2012)

<sup>328</sup> Posner (2010): 116

<sup>329</sup> Petch (2011)

<sup>330</sup> Utzig (2010): 11

<sup>331</sup> Utzig (2010): 3

#### 5.2.4.4.5 Germany

BaFin has refined and extended its requirements for risk management (MaRisk) following the global meltdown. These extensions include more ‘rigorous and wide-ranging international risk management standards’.<sup>332</sup> To confirm this, a 2008 was sceptical of rating agencies, particularly towards relying on these in national regulation.<sup>333</sup> Nevertheless, there have not been any remarkable codified shifts in German policy and authorized CRAs will continue to play an important role in the Germany banking system.

#### 5.2.5 Findings

The preceding section has examined how the US, Canada, the UK and Germany have interpreted the different categories that have dominated the regulatory reform discussion. Restricting the discussion in such a way indicates that there has already been a great deal of coordination achieved. If countries agree upon which factors should be involved in the overhaul of their banking systems, they share quite extensive common grounds. Some of these factors, such as capital adequacy and relying on ratings agencies are remnants of previous discussions that have re-emerged, whilst leverage and liquidity have been new and hot topics of the latest rounds.

On the other hand, as the cases show, there are both prevalent as well as possible differences in the political acceptance of globally standardized reforms. As the regulation of banking is highly technical and its international coordination is often delegated to experts, the apparent minor differences in regulatory interpretation could be larger than what they first appear. The following analysis sector will attempt to examine the effects of these apparent differences.

### 6. Analysis

This discussion will focus on the similarities and contrasts in policy that were observed in the preceding chapter and thus address international outcomes, or the second step of the procedure. Looking at how the cases compare, the aim is to understand whether the cases have converged or diverged in reregulating global finance. Understanding the four different cases in the preceding chapter provides a fundament for exploring developments that deviate from status quo regulation.

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<sup>332</sup> Gluck et al. (2011): 22

<sup>333</sup> The Issing Committee (2008) as reportet in Utzig (2010): 10

This discussion will ultimately show the global divergence in banking regulation. The main indicators are the break up of the ‘club’ negotiation environment of Basel and the simultaneous emergence of increased inter-state regulatory competition as predicted in section ‘4.2’. The agreements reached in the most recent round of Basel are at best ‘sham standards’ (see table 2 in section ‘3.2.3 The international regulatory coordination model’). This indicates a higher degree of conflict, or divergence, than expected by convergence theory. To introduce the analysis according to the two-step procedure, we must first complete the model description by outlining the international intentions and influences of the different countries. According to Bennett we should here focus on policy goals. These will help contextualize the model cases when we discuss them in terms of the theory.

### 6.1.1 The US

The initial American response to the crisis was inwardly focused much in the way we saw happened following the junk bond crisis and lead-up to Basel I. This response, encapsulated in the DFA followed the Lehman Brothers’ default and targeted specifically breaking up universal banking and reconfiguring market infrastructure.<sup>334</sup> It is the keystone to the financial reform structure in the United States and is thus assumed by some analysts to be influential at the international level, despite the aforementioned inward focus.<sup>335</sup>

Not only has the US focus been introverted, it has also been fast-tracked. The US was the first among the world’s leading economies in drafting its new regulatory architecture, this being signed by president Obama roughly three months before the G-20 endorsement of Basel III.<sup>336</sup> Furthermore, it was the Obama administration that took the lead internationally with regards to regulatory reforms by arguing against hybrid capital and codifying leverage rules.<sup>337</sup>

The DFA ‘pays little real attention’ to international cooperative efforts.<sup>338</sup> Cooley and Walter claim that the Obama administration and the US Congress assumed that as the DFA reforms were the first to appear, they would inevitably become the template for global financial

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<sup>334</sup> Tropeano (2011): 61

<sup>335</sup> Acharya et al. (2011): xviii

<sup>336</sup> Acharya, V., Cooley, T., Richardson, M., & Walter, I. (2011b). *Dodd-Frank: One Year On*. Retrieved December 6, 2011 from VoxEU.org: [www.voxeu.org/sites/default/files/file/proofs.pdf](http://www.voxeu.org/sites/default/files/file/proofs.pdf): 14

<sup>337</sup> Buckley and Howarth (2010): 134

<sup>338</sup> Cooley and Walter (2011): 48

restructuring.<sup>339</sup> This assumption is reflected in the attitude on Basel III implementation; draft regulations are not yet available and big banks are placing the implementation on the sidelines in contrast to racing to apply the demands of the DFA.<sup>340</sup> On the other hand, EU leaders have made public statements that they do not intend to follow the recipe given by the US.<sup>341</sup> Also Comparably to the junk bond crisis, the international influence of US regulators is likely hampered by its reputation of inefficiency and overlapping agencies. It is therefore unlikely that the US will assertively enact its position on the international level.<sup>342</sup>

It should be mentioned that although the DFA and Basel have similar objectives, there are important differences. These are found particularly in the capital requirements and the implementation schedules.<sup>343</sup> The differences between the Basel guidelines and the legal framework of the DFA undermine the international consensus and open for the possibility of Basel III arbitrage.<sup>344</sup> Particularly the Volcker restriction stands out as a major difference. It is not surprising that it has caused trouble among domestic actors. More striking, however, is the protest it has generated from other actors, amongst them Canada and the EU, who fear that the Volcker Rule will disrupt liquidity in the international market.<sup>345</sup>

Noticeably, the DFA does not clearly or consistently approach the financial sector; it combines a ‘great deal of modified laissez-faire’ with a lack of anchoring in a definition of regulatory responsibilities and functions.<sup>346</sup> The concern here is that it does nothing to contain the fragmentation of the US banking system, yet restricts the consolidation of international standards by differing from Basel guidelines. The US has, through this act, taken a discernable stance as an autonomous actor in the face of global governance efforts.

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<sup>339</sup> Ibid.

<sup>340</sup> Hilley, J. T. (2011 19-10). *In Race to Adopt Dodd-Frank, US Falls Behind on Basel III*. Retrieved 2011 30-11 from Housingwire: [www.housingwire.com/2011/10/19/in-race-to-adopt-dodd-frank-us-falls-behind-on-basel-iii](http://www.housingwire.com/2011/10/19/in-race-to-adopt-dodd-frank-us-falls-behind-on-basel-iii)

<sup>341</sup> Weir, K., & Balmer, C. (2010 23-01). *Europe Welcomes Obama Bank Plan, Won't Imitate It*. Retrieved 2011 27-10 from Reuters Financial Regulatory Forum: <http://www.reuters.com/article/2010/01/22/us-obama-financials-idUSTRE60K0RW20100122>

<sup>342</sup> Singer, D. A. (2010). Uncertain Leadership: The US Regulatory Response to the Global Financial Crisis. In E. Helleiner, S. Pagliari, & H. Zimmermann (Eds.), *Global Finance in Crisis: The Politics of International Regulatory Change* (pp. 93-107). New York, NY, United States: Routledge: 94

<sup>343</sup> Avery, A. W. (2011 January). *Basel III v Dodd-Frank: What Does it Mean For US Banks*. Retrieved 2011 7-December from Who's Who Legal: <http://www.whoswholegal.com/news/features/article/28829/basel-iii-v-dodd-frank-does-mean-us-banks/>

<sup>344</sup> Ibid.: 3

<sup>345</sup> Bernanke (2012); Mackenzie, M. (2012, January 31). *Volcker Downplays Risk to Bond Markets*. Retrieved February 8, 2012 from FT.com: <http://www.ft.com/cms/s/0/b69ce56a-4c46-11e1-bd09-00144feabdc0.html>; and Menon, N., & Vieira, P. (2012 13-February). *Canada Takes Shot at 'Volcker'*. Retrieved 2012 27-February from The Wall Street Journal: [online.wsj.com/article/SB10001424052970204883304577221072367627462.html#printMode](http://online.wsj.com/article/SB10001424052970204883304577221072367627462.html#printMode)

<sup>346</sup> Cooley and Walter (2011) 45

### 6.1.2 Canada

Canada had the potential to play an important role in Basel III negotiations. As noted, Canada emerged out of the crisis relatively unscathed, and its conservative minority government was eager to not only exploit this domestically, but also on the international stage. As we have seen in the discussion of Canadian banking regulation, the main principle guiding policy makers was prudence. This was therefore the core to finance minister Jim Flaherty's international proposal.

More importantly however, Canada sought to eke out space for its own autonomy. Canada is perhaps the state most expected to succumb to great power coercion, simply due to its proximity to the US. Canada lobbied to moderate the new minimum capital levels in order to ensure the possibility of different business models and national regulatory frameworks.<sup>347</sup> This suggests that Ottawa was reaching out to establish normative precedence to support its own deviance from the US model. Rather than aggressively front its own successful regulation as an ideal for global standard, Canada sought to preserve its own internal policy preferences.

Therefore, Canadian rhetoric and position of moral superiority did not translate into substance in the form of driving policy. Lesser breakthroughs were celebrated. For example, upon one apparent breakthrough for a Canadian proposal (bank debt as equity), Mr. Flaherty stated that 'Canada continues to play a lead role in focusing financial reform discussion.'<sup>348</sup> Other perhaps more unbiased commentators have been disappointed by the Canadian impotency at the global level. Mark White of the OSFI claims Canada were 'doves' in the Basel III negotiations, arguing that the country's relative strength and moral ground following the crisis came from an innate culture rather than regulation-based prudence.<sup>349</sup> This is most likely a symptom of the attempt by Ottawa to maximize its individual freedom and focus inwardly rather than promote itself as a global model.

In fact, the Canadian bank system is characteristically inwards-focused as exemplified by the lack of exposure to the same 'toxic' debt that European and US institutions were subject to. As mentioned, the few bigger banks are quite dominating and have a history of being involved in

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<sup>347</sup> White, M. (2011, January 11). *Basel III: Balancing of Risk and Regulation*. Retrieved October 10, 2011 from OSFI: [http://www.osfi-bsif.gc.ca/app/DocRepository/1/eng/speeches/RBC20110111\\_e.pdf](http://www.osfi-bsif.gc.ca/app/DocRepository/1/eng/speeches/RBC20110111_e.pdf)

<sup>348</sup> Vieira, P. (2010 19-August). *Basel Watchdogs Back Canada's Banking Scheme*. Retrieved 2011 10-October from Financial Post: <http://www.financialpost.com/Basel+watchdogs+back+Canada+banking+scheme/3417943/story.html>

<sup>349</sup> White (what Basel III does), supported by findings in Roy, Turk-Ariss, and Redjah in John Raymond Labrosse: *Managing Risk in the Financial System*: 86

their own regulation. This, in combination with Canada's seemingly inwards focused market structure, suggests that nationally imposed strict regulation is likely to be welcomed to corral the domestic market and lock out foreign competitors.<sup>350</sup> Apparently there are strong interests for Canada to maximize its national autonomy.

### 6.1.3 The EU

The focus in this analysis is on the state, however a few points should be noted regarding the inter-national cohesion of the EU given the moniker *Europeanization*.<sup>351</sup> Strikingly, members of the EU took an early coordinated stance in responding to the GFC, specifically agreeing on a common 'line' on international financial issues for the 2009 G20 summit and the same year's Spring European Council.<sup>352</sup> Cohesive action on the international stage adds leverage to the EU bargaining chip, something Germany has been eager to develop.<sup>353</sup> If the various members agree on a common direction, it is likely that they will act in a europeanized way. Arguably the EU has succeeded in this and as a result been one of the most active proponents on international reform.<sup>354</sup>

Because the EU position on finance is distinctly different from the international regulatory trend of market liberalization,<sup>355</sup> the success of Europeanization is interesting. The EU position combines free market determinants with socially protective regulation.<sup>356</sup> In addition EU policy priorities have shifted from ensuring level internal competition to providing financial stability.<sup>357</sup> Although there is an agreement around such principles, the EU has struggled to cohesively combine contending European financial models as made apparent by the squabbles between Germany and the UK. If the EU is cohesive in promoting these preferences it will likely increase global divergence.

In a discussion of EU cohesion, Elliot Posner argues that despite existing national rivalries and the 'frequent absence of a single voice', the EU has expanded its international agenda as a

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<sup>350</sup> Salmon, F. (2011 2-November). *All Bank Regulators Are Captured*. Retrieved 2012 8-January from Reuters: <http://blogs.reuters.com/felix-salmon/tag/basel-iii/>

<sup>351</sup> Hodson, D., & Quaglia, L. (2009). European Perspectives on the Global Financial Crisis: Introduction. *Journal of Common Market Studies*, 47 (5), pp. 939-953: 946

<sup>352</sup> *Ibid.*: 946

<sup>353</sup> Zimmermann (2010): 128

<sup>354</sup> Moschella (2011): 108

<sup>355</sup> *Ibid.*: 98

<sup>356</sup> *Ibid.*

<sup>357</sup> *Ibid.*: 109



competitor to US financial leadership.<sup>358</sup> He argues that ‘more than merely ensuring level playing fields, EU representatives (...) seek to use their decade-long expanding and newly developed capacities and regulatory approach to turn Europe into a regulation-maker’ rather than adopt US moulds.<sup>359</sup> European regulators have found themselves asking ‘why converge with the US, when the US financial system is to blame for the crisis’.<sup>360</sup> This shift appears to have coincided with the decrease in political relevance of London based financial actors after the crisis.<sup>361</sup>

Arguably, the EU financial system has different needs than the general requirements of Basel tailor to. This is the stance Karel Lannoo takes in her recommendations for CRD IV.<sup>362</sup> For instance, Europe’s recent stress tests that emphasized the core Tier 1 ratio, were unable to point out major flaws in the banking system. The EU should therefore give the leverage ratio a much more central role compared to Basel.<sup>363</sup> These specific conditions stimulate EU actions that are divergent from (most noticeably) the US model.

#### **6.1.4 The UK**

It is interesting to see the apparent British paradigm shift under the pressure of the GFC and the consequent decrease in confidence in liberal financial practice. Whilst some predict that this is probably not a lasting case,<sup>364</sup> British regulators actually appear to have left the opportunity open for future strengthening of Westminster control. Major reforms have been instigated despite City reluctance and a political passing of batons between prime ministers Brown and Cameron.

With regards to European convergence, the UK voiced concerns with some European reform proposals,<sup>365</sup> but on the other hand emerged as a policy entrepreneur in the initial response to the crisis.<sup>366</sup> The City has traditionally viewed EU regulation as a vital threat to its global competitiveness.<sup>367</sup> When the reform proposals collided with the British policy paradigm in their decisive turn away from market-based regulation, this resulted in demands by the financial sector in London for continued UK independence. However, the market-making approach had been

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<sup>358</sup> Posner (2010): 116

<sup>359</sup> Ibid.

<sup>360</sup> Holmquist (2009): 5

<sup>361</sup> Posner (2010): 111

<sup>362</sup> Lannoo (2012)

<sup>363</sup> Ibid.

<sup>364</sup> Hodson and Mabbett (2009): 1054

<sup>365</sup> Quaglia (2010)

<sup>366</sup> Quaglia (2009)

<sup>367</sup> Zimmermann (2010): 133

delegitimized also in British political circles. Consequently, the UK has seen a collision of interests in responding to the GFC. The result of this collision has been an opportunity for Westminster to take advantage of its ability to implement fundamental reforms.

Much of the UK regulatory reform has happened internally, from the bottom-up. It has instigated its own commissions, such as the aforementioned Independent Banking Commission, to generate policy recommendations. Furthermore, the UK has been an entrepreneur of national policy, most specifically in the immediate aftermath of the crisis.<sup>368</sup> There has been a reluctance to secede power to regional authorities, and a drive to allow individual (stricter) stability demands than those of the EU. Rather than lobby the EU to accept its standards, Britain has been concerned that EU agreements would impede its reforms.<sup>369</sup> Part of this effort seems to have been directed by City interests in opposition to those of the Union.<sup>370</sup> This policy direction has caused some concern with continental EU members who fear that exaggerated individualism could harm European unity.<sup>371</sup> This sets Britain apart from particularly Germany, where policy has been channelled primarily through the EU framework.

The result of this seems to have been a political recapture of some areas of financial governance rather than capitulation to City demands. Britain has been nationally proactive in recasting technical demands such as capital demands as well as in overhauling its banking system through returning to central bank oversight and developing the Vicker's reform.

### 6.1.5 Germany

The disillusionment with Anglo-American neoliberalism has triggered a 'rethink' of previous regulatory models, consequently stimulating activism amongst contenders to these models.<sup>372</sup> Germany has emerged as a contributor to this activism. Berlin's response to the crisis was in part influenced by the segmented nature of the banking sector, but also by the relative success of banks to solve their problems on an individual basis.<sup>373</sup> This led to a response that was mostly aimed at addressing the international financial structure and hence the focus on domestic

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<sup>368</sup> Quaglia (2009)

<sup>369</sup> Goff, S., & Parker, G. (2011 19-December). *Brussels Eases Fears on Vickers Reforms*. Retrieved 2012 5-January from Financial Times: <http://search.proquest.com/docview/912010157?accountid=12870>

<sup>370</sup> Johnson, J. (2011 5-December). *Don't Drape the City in a Union Flag: it's an Asset to All Europe*. Retrieved 2011 7-December from Financial Times: <http://www.ft.com/cms/s/0/5196bc4a-1d2a-11e1-a134-00144feabdc0.html>

<sup>371</sup> Barker, A., & Masters, B. (2012 22-January). *EU Regulator Urges Cameron to 'Play the Game'*. Retrieved 2012 8-February from Financial Times: [www.ft.com/intl/cms/s/0/3523b340-4531-11e1-be2b-00144feabdc0.html#axzz11he9SepM](http://www.ft.com/intl/cms/s/0/3523b340-4531-11e1-be2b-00144feabdc0.html#axzz11he9SepM)

<sup>372</sup> Moschella (2011): 108

<sup>373</sup> Hardie and Howarth (2009): 1031

regulation has been delayed. One important point to highlight is that the EU's policy converged with the coordinated-market approach promoted by Germany, emphasizing Germany's role as a policy entrepreneur.

However, Germany, like the UK has not been an active proponent of increased prudency on the international level. It has not unilaterally moved to strengthen the quality of capital of European banks, and neither has it pushed actively for the new Basel agreement.<sup>374</sup> In fact, the German government's policy on capital adequacy has contradicted its norm of promoting tighter EU and international regulation.<sup>375</sup> Arguably, this responsive and retroactive approach is partly due to the nature of Germany's banking sector, as German politicians have seemed generally positive to global initiatives.

In this light, it is interesting to note that an international approach is strongly contested by Germany's publicly administered banks. On the other hand, private sector banks have been in tune with EU proposals. Between these two sectors, the commercial banks have been reluctantly in agreement with European supervision. The federal government has been influenced by the lobbying efforts of all sectors and its position has consequently been obfuscated.<sup>376</sup> It has issued both messages of support for international cooperation as well as resistance to certain aspects, such as the Basel implementation timeframe, the definition of capital reserves, and leverage ratios. The federal government appears to have raised this issue to the transnational level, placing its trust in EU decisions to break up the power structure of its banking sector. By surrendering much of the legislative decision in the hands of the European parliament, the German government has thus far been able to untie its hands in some cases, as for example with capital requirements and liquidity.

There are however caveats. Berlin has for example been remarkably out of concert with London with regards to two particular aspects; disclosure of leverage ratios and treatments of banks that own insurance companies. The most prominent discord is with regards to leverage ratios, perhaps Europe's biggest concern. Whereas London has promoted an advanced date for leverage ratio

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<sup>374</sup> Buckley and Howarth (2010): 132

<sup>375</sup> Ibid.: 135

<sup>376</sup> Ibid.: 126

disclosure, Germany is a proponent of a three-year delay to Basel's original deadline.<sup>377</sup> This marks a major political issue between the two EU powers, and consequently a split in the unified EU stance. The next stage of this process will likely prove more difficult, when EU directives are implemented into national legislation. As German banks have already gained concessions at the EU stage, it is plausible that they will do so nationally also.

## ***6.2 Convergence or Divergence?***

### **6.2.1 Globally**

These cases show that there are indicators of both convergence and divergence between the policies for the restructuring of bank regulation following the economic downfall. There is an overall agreement upon the factors that are to be tweaked, such as capital requirements and leverage, liquidity, and the regulation of risk evaluation. There is also a consensus regarding the need to reregulate. On the other hand, it is noticeable that there has been a remarkable lack of coordination, as bilateral communication seems to have broken down following the crisis.<sup>378</sup> Arguably the lack of great power alignment has harmed the global efforts by limiting significant breakthroughs comparable to those driven by the cooperation of Britain and the US in Basel I negotiations. The resulting global standards are therefore strongly indicative of sham standards and state divergence.

#### *Sham Standards*

One particular finding that indicates divergence is the development of the BCBS. Not only does this entail the committee's increased membership, but also the direct results of this increase in the form of inability to address pertinent issues. Looking at Basel, the global attempt at reregulation has focused on regulating the activities of individual institutions rather than restructure the entire system. This leaves the shadow banking system that was so problematic in the escalation of the crisis largely intact.

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<sup>377</sup> Barker, A. (2012 22-January). *Paris and Berlin Seek to Dilute Bank Rules*. Retrieved 2012 8-February from Financial Times: <http://www.ft.com/cms/s/0/7f8485a8-4500-11e1-a719-00144feabdc0.html>

<sup>378</sup> Atlantic Council (2010): 7

Analysts have pointed to this as a major flaw in the global regulatory reform.<sup>379</sup> Capital requirements do for example not prohibit banks from holding asset portfolios with high correlation of returns.<sup>380</sup> Simply put, this means that although banks might be sufficiently capitalized, the capital they hold depend on the same risks and if a problem is found in one institution's capitalization it is likely to become systemic. In this way, Basel has not made any significant developments outside of the committee's continued dependence upon elaborate technical solutions to regulation.

The general conclusion one can make concerning the global regulatory reform (as opposed to individual and internally focused reforms) is, as Tony Porter puts it, that it has not perhaps involved aggressive independent promotion of national interests, but rather focused on informal groupings and technical standards.<sup>381</sup> National competitiveness is mediated through a relegation of issues to technical discussions. This indicates a definite disinterest in handling the important reforms at the international level and so far results predict a slow and uneven implementation with room for deviation between national economies as in the example of sham standards.<sup>382</sup> The lack of US leadership is likely to have predicated this ambiguity, and the EU has clearly not amassed enough influence to decisively impact the situation.

This indecisiveness comes at the expense of the more difficult governance changes needed.<sup>383</sup> Nicholas Veron notes that in an era of reregulation, it is much more difficult to keep global consistency, or convergence, than in times of pacific markets when only light- touch regulation seems necessary.<sup>384</sup> In reregulation, he claims, decisions are of necessity at least partly determined by local politics.<sup>385</sup> This has clearly been the case for global banking regulation following the global crisis.

The new BCBS recommendations have not taken any remarkable steps to mitigate the regulatory reliance on risk agencies, relying heavily on risk modelling as the method of managing risk rather

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<sup>379</sup> See for example Gorton, G., & Metrick, A. (2010, Fall). Regulating the Shadow Banking System. *Brookings Papers on Economic Activity*, pp. 261-312; Acharya, V. V. (2009, September). A Theory of Systemic Risk and Design of Prudential Bank Regulation. *Journal of Financial Stability*, 5 (3), pp. 224-255.

<sup>380</sup> Acharya (2009)

<sup>381</sup> Porter (2010): 57

<sup>382</sup> Zimmermann (2010): 123

<sup>383</sup> Porter (2010): 57

<sup>384</sup> Acharya et al. (2011b): 93

<sup>385</sup> Ibid.

than governing oversight.<sup>386</sup> This specific area marks a convergence between the interests of advanced market countries like those analyzed here, where firms have the competitive advantage in terms of familiarity with assessment techniques as compared to less developed economies.<sup>387</sup> Most importantly, the outcome clearly favours the US market, as it plays host to most CRAs. The political importance of centralized and nationally grounded CRAs further supports the antithesis to the assumption that decentralized markets dominate global financial policy.<sup>388</sup>

The one significant global move towards handling systemic collapse is the inclusion of leverage and liquidity requirements.<sup>389</sup> These standards augment the pre-existing capital requirement demands by addressing endogenous systemic risks that were previously neglected. This segment of Basel indicates that, despite some of its flaws, the accord was a return to increased political involvement.

In conclusion then, the evolution of Basel in terms of membership and purpose indicates that the global standards for banking regulation are irrelevant to some of the main concerns of the affected members. According to the typologies of international cooperation (see table 2 in section ‘3.2.3 The international regulatory coordination model’) this suggests that there are disputed conflicts between the members of the Committee and therefore policy divergence.

### **6.2.2 National dilution**

Concomitantly there is a growing split between Europe and the US that suggests a diverging and competitive relationship at the inter-national level. None of the models examined here are convincingly similar. One observation that stands out is the intention by all these countries to pursue the implementation of international standards through already in-place legislation or systems. Doing so suggests that the standards will be significantly diluted as a result of the differences noted in this discussion. For instance, the major reforms in the EU proposals are more closely aligned with Basel prescriptions as compared to the DFA which is more intent on segregating different types of banking as well as reforming the market infrastructure.<sup>390</sup> This

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<sup>386</sup> Porter (2010): 57

<sup>387</sup> Ibid.

<sup>388</sup> Bruner and Abdelal (2005): 191

<sup>389</sup> Porter (2010): 57

<sup>390</sup> Tropeano, D. (2011 Summer). Financial Regulation After the Crisis. *International Journal of Political Economy*, 40 (2), pp. 47-62.61

might reflect the EU's willingness to revert to internationalism and a general EU respect for international norms,<sup>391</sup> as opposed to US centripetal individualism.

Harmonization of standards, as for example through Basel, does not necessarily translate into convergence. As noted, the agreement does not handle the most contentious issues, and even those areas it does address are mostly handled within the national framework. This has been found to be true of other international regulatory regimes also.<sup>392</sup> The following discussion will revisit some of the specific country impulses and show how focusing on states reveals a divergence in policies.

According to the predictions, we should see a high degree of conflict accompanying IGO sham standards. This would indicate no coordination between the states examined below those sham standards. Thus, although we would expect  $\delta$ - convergence (between states and an exemplary model), these are meaningless as a measurement of convergence in the case of sham standards, and we should therefore not see  $\sigma$ - convergence (between state models).

This study has examined policy goals (by looking at the effects of the crisis and international intentions), policy content (by looking at specific regulatory requirements), policy instruments (by looking at central legislations and actors), and policy styles (by examining banking sectors). Amongst these there has been surprising variance.

### ***6.2.2.1 Policy goals and styles***

The most significant differences are found in the diverging policy goals. All four countries were affected differently by the GFC. Canada notably least so, whilst the crisis was particularly detrimental to the US's position as the global leader on financial regulation. These two countries were at opposite ends in terms of the imminence of restructuring. This is shown in their regulatory overhaul; the US underwent the most complete restructuring of its financial regulation while Canada barely went through any. As pointed out, the US system has been reigned in by a strong although fragmented bureaucratic reform. This, the DFA will certainly impose major costs on the US financial sector, and it could be a cause of concern whether the costs of coordinating it with Basel recommendations will be too high and as a consequence neglected.

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<sup>391</sup> Atlantic Council (2010): 5

<sup>392</sup> Drezner (2007): 13

Europe, in this case Germany and Britain, was also affected by the crisis. This impact has been different, as it has prolonged itself extensively. Nevertheless, Europe has the opportunity to assert its influence over global finance with the downfall of neoliberal laissez-faire regulation. There are major benefits to regional cooperation to counterbalance some of the benefits to uncoordinated action. Whilst the economic collapse has left both Canada and Europe in a position to fill the void left by the decline of US financial leadership,<sup>393</sup> it is the EU that is the most likely to do so in divergence. Between Germany and Britain, the latter is definitely the case where the most restructuring has taken place. Remarkably, there are few indicators that this restructuring has been shaped by path dependency.<sup>394</sup> Germany on the other hand, is relying on EU reforms to guide its restructuring. Zimmermann argues that Germany's dependence on the union stems from its realization that the chances for the acceptance of its proposals vastly improve with EU backing.<sup>395</sup>

The selected data brings attention to the US role in leading by example as opposed to doing so coercively. This appears to have been the assumption by US authorities also, as Washington was the first of leading economies to present a drafted proposal for restructuring. However, this role has not been strongly defined by action at the international level. Leading by example can nevertheless be a powerful tool. In the case of Basel I, being first in the race to regulate and leading the negotiations by example was highly efficient for the US and Britain. Arguably, the US has done so alone this time around. The fact that Washington was unable to coordinate with the UK in the same way as previously underlines the divergence of the direction of the British financial reform. Without Basel to coordinate the global reform, there has been more room for divergence, which the countries examined in this study have taken advantage of.

The international coordination model also suggests that the EU would in the case of global competition aim to confront US hegemony. This suggests that the EU will be able to coordinate its position on bank regulation. Daniel Mugge finds a U-shaped relationship between the degrees of delegation and the European presence on the global stage.<sup>396</sup> In this relationship, the decisiveness of Europe depends on how power is delegated. If nations are given high degrees of

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<sup>393</sup> Leblond (2010-2011): 60

<sup>394</sup> Zimmermann (2010): 123

<sup>395</sup> Ibid.

<sup>396</sup> Mugge, D. (2011). The European Presence in Global Financial Governance: a Principal-Agent Perspective. *Journal of European Public Policy*, 18 (3), pp. 383-402: 384



autonomy and there is no common European delegation, there will be a high degree of European presence, and likewise if a common EU delegation is given substantial authority. On the other hand, if neither of these conditions is met, EU members' hands will be tied. By the predictions of this model, the European presence at Basel was significant, as national delegations were given priority. A European takeover would be possible if its members are able to coordinate amongst each other.<sup>397</sup> In fact, we have seen that the EU has been one of the most active actors in the negotiations of international financial reform, where it has fronted the widening of regulatory scope.<sup>398</sup> The position taken by the EU suggests that we are going to witness growing transatlantic tensions due to diverging interests.<sup>399</sup>

Particularly Germany has strived for Europeanization. However, the process has not been seamless and can be argued to be theoretically imposed rather than actual. Nevertheless, with the ability to make top down decisions in Brussels, core member state differences should not be exaggerated.<sup>400</sup> The potential achievements of EU cooperation have also increased with the inefficiency of Basel. This has added weight to the benefits of inter-EU cooperation and subsequent competition with other great powers. With more room to manoeuvre, it is not surprising that the union has asserted itself.

The US has already shown through the neglected implementation of Basel II that its willingness to accept costs related to financial regulatory reform is reluctant at best. On the other hand, the benefits of coordinating on banking standards do seem enticing enough for Washington to accept the governing consensus on necessary regulatory categories, such as capital requirements, leverage, and liquidity. The significance of this is the inferred possibility of the coexistence of overarching international standards and such blatant principal differences such as the Volcker rule. This suggests that US authorities do not trust international standards to sufficiently stabilize its banking system.

The global sham standards and consequent national policy autonomy has been important to Canada. Although Ottawa's standards, such as the definition of leverage, sometimes deviate from their US counterparts, they do not by themselves signify an intentional challenge to US standards

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<sup>397</sup> Ibid.: 398

<sup>398</sup> Moschella (2011): 108

<sup>399</sup> Ibid.: 109

<sup>400</sup> Buckley and Howart (2010): 132

in light of the lacking Canadian leadership in international negotiations.<sup>401</sup> Canada was unable to successfully lobby its high standards for leverage targets on the global stage. This shows that Canada by itself imposing higher standards than the US does not threaten the US position on these standards. Its otherwise passenger role in Basel demonstrates Ottawa's reluctance to globally challenge its neighbour. Canada has managed to avoid this at the same time as ensuring the possibility of preserving its status quo regulatory regime. This is possible due to the national divergence that is allowed by the impotent global governance.

The breakup of the Basel club arguably affects the freedom of Canada to experiment with other allies. In its involvement in the recent negotiations, Canada appeared interested in protecting its autonomy. In addition, the US's coercive influence has been reduced without the normative backing of the IGO together with the deflated influence of the Anglo-American model. Depending on future development we could see Canada approach the EU further with the potential cementing of the EU model. However, in the face of increased divergence and the possible competition emerging, Canada is expected to conform to its neighbour. With Canadian banks adapting to new US regulation, Canada's incentive to partner with the EU decreases.

#### ***6.2.2.2 Policy content***

Noticeably, there has been a split in weighting of these different factors as shown in the variance in policy content. There are diverging understandings for how to implement the main policy instrument, capital requirements, specifically in terms of defining eligible capital. Furthermore, with regards to leverage, the US and Canada both have prior measures intended to curb irresponsible behaviour whereas Europe's banks have mostly been unregulated in this regard and consequently entered dire straits. It is predictable that the most resistance given to increased stringency in capital requirements are voiced by German actors, as Germany is the country most reliant on banks for the functioning of its financial system. There also appears to be a definite opening for a transatlantic split over the implementation of the new standards. This split has been augmented by the advancing bank crisis in the Eurozone, both separating Europe from the recovering US as well as underlining the importance of cooperation and European unity. However this crisis has also decreased the financial clout of the EU and might make it more

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<sup>401</sup> Leblond (2010-2011): 71

difficult to emphasize its leadership and perhaps driving outliers like the UK away from the continental position.

The political coordination of EU regulators has also been an interesting development to this debate. EU institutions with the exclusive right to introduce new legislation have undertaken a u-turn in their most recent position, abandoning their political alliance with London-based financial coalitions. This evidence questions the explanatory power of structural power or convergence theory, as it would predict the opposite occurring.<sup>402</sup> Eliot Posner points to signs that officials in Brussels have reached out to other more prudent groups for an integrationist coalition that is more importantly based on a different set of regulatory principles compared with those of London.<sup>403</sup> In this reconfiguration the US model was also considered and concluded to be politically unacceptable as a model to the European regulatory reform.<sup>404</sup> In Europe, conscious choices are being made to the evolution of the Union's financial model, and these choices seem to be bringing it further away from the Anglo-American model.

As discussed, the US has tried to take an indirect leadership role in framing the new global financial governance through its own internal reforms found in the DFA. By doing so they have given a clear signal for how they stand politically in the ongoing restructuring. It should be noted that the independent solution is a natural response to the global perception that the US could somehow be blamed for the crisis and not necessarily a politically driven attempt to distance the American reform from that of the global level. Nevertheless, both these factors point to a distinguishable US paradigm for the construction of its policy content. Firstly, Washington has defined its reform through the DFA and secondly, there is a global perception of a (flawed) US system that has led to other states distancing themselves from this system.

One of the major differences relates to Universal banking. Queries concerning universal banking have re-emerged as part of the discussion of systemic collapse. Reforms are found in both the UK and the US, the two countries most dependent on their financial system for financing. Of the two cases, the Vickers and Volcker reforms, the American Volcker Rule is the one that directly inhibits universal banking, whereas the UK's Vickers ringfence only interferes with the transfer

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<sup>402</sup> Posner (2010): 111

<sup>403</sup> Ibid.

<sup>404</sup> Ibid.

of funds between affected and non-affected sectors. These individual initiatives are a major illustration of the way that jurisdiction-specific regulatory solutions have become more prevalent following the crisis.<sup>405</sup>

The reluctance towards universal banking has historical precedence in both the US and the UK.<sup>406</sup> As mentioned, both countries saw the incentives for change rise with the spread of the crisis and disillusionment with the Anglo-American model, and it is therefore not surprising that the biggest changes are happening here. Evidently these two countries aim towards finding their own individual solutions to systemic collapse rather than promoting these to the international level. This reluctance to do so points to prominent difficulties between countries. The fact that these issues cannot be adopted at the Basel forum shows that the highly technical discussion neglects bigger systemic deviations.

### ***6.2.2.3 Policy instruments***

As seen in the section presenting the data, the two main instruments worth discussing in this context are the DFA and the fourth CRD. This is because Canada has not passed any overarching reform legislation and Britain and Germany are highly coordinated with the CRD. Where the DFA was noticeably conditional on national imperatives, CRD 4 is remarkably international in its reliance on Basel agreements.

For the US, the nature of the DFA makes shying away from major reforms probable. The preference of the financial sector of the US economy has been substantial enough to ensure that the overhaul fits in the vein of previous policies. There are enough uncertainties in the DFA to enable lobbyists to disarm it in its future development. As discussed, many analysts are concerned that the Act will not be the overhaul it aims to be. It is vague with regards to addressing pre-existing channels of financial alchemy. Furthermore, it is assumed that the Act gives incentives to the continuation of the type of creativity that led to the GFC. These are all signs that market forces influence US policies.

On the other hand, there are major attempts at regulatory recapture, particularly in the return to American scepticism of universal banking with the Volcker Rule. This is a decisive turn away

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<sup>405</sup> Veron (2012): 10

<sup>406</sup> Atlantic Council (2010): 3

from any converging format for bank regulation in itself. Highly autonomous, the Volcker decision could cause problems with other countries aiming to standardize banking across borders. The rule would impose significant costs on foreign banks wanting to incorporate in the US market.

As pointed out, the EU's banking sector is coordinated through the CRD and in a particularly detailed way in the fourth version. This version inhibits the diverging interpretations that have characterized earlier efforts, particularly in terms of capital requirements (article 87). However, the direction the EU has taken is practically distinct from that of the US in that they have mostly waited for an international decision prior to instigating any internal reform. Possibly, this reflects the decentralized authority structure of the EU, where external legitimacy could strengthen an internal decision.

### ***6.3 Competition- Divergence?***

There are significant benefits to global regulatory coordination, mostly to do with reduced transaction costs,<sup>407</sup> but also related to global consistency and stability. These benefits have lingered in agreement since the first Basel accord, where they were prominently discussed as a reaction to the chaos of the previous bank failures. The established tradition of recognizing these benefits has perhaps been the most important reason as to why a third round of negotiations has been attempted. However, there has been a major shift in the functions of Basel that inhibits the plausibility of international coordination. This has increased the price of cooperation in the regulator's dilemma that encapsulates global financial regulation by increasing the diversity of actors. The increasing diversity of members as well as increasing number of smaller powers that might coordinate to oppose great power capture of the organization (as shown in the first Basel accord negotiations) has emphasized the difficulties of coordination.

Previously the discussion has centred on the differences between laissez-faire regulation and prudent oversight, whereas the GFC brought on a new wave of global regulation and subsequently normalized prudency. This dedication to reregulate had a global effect, although not all of the countries in this analysis took an individual part of it, and they all pursued this vague goal differently. Both Canada and Germany have been slow to implement major changes to their

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<sup>407</sup> Drezner (2009): 44

financial regulation. As has been discussed, this is due to Canada's success coming out of the turmoil and Germany's expectations for European cooperation, and therefore can also be considered reactions to the crisis.

In Drezner's international standards coordination game, the EU is a clear candidate to oppose US hegemony, thus also making EU members good candidates for this analysis. The EU has perhaps taken its strongest stance to date (in relation to banking regulation) with the fourth CRD. This directive inhibits national deviations as well as dictates a coordinated European stance on Basel III. It also points to a stronger European acceptance of international decisions than found in the US. It is difficult to compare US and EU models however, particularly as the decision-making process in the US and the EU are markedly different both in terms of timing and structure.<sup>408</sup>

Therefore an obstacle is arguing the existence of a united Europe comparable to the US. When studying the country cases, Britain seems to be very much on the fence on the matter and could be a deciding factor in whether the EU becomes a legitimate contender to the US. The implications of the DFA could be decisive in driving the UK to coordinate with the rest of Europe. Reluctance to accept the threats of the DFA on global competitiveness seems to be an important factor also bringing Canada to criticize the American reforms.

If we compare the case of coordinating the current regulatory reform with the process witnessed in the Basel I negotiations, it is clear that there has been no solidified leader on global standards. Whereas Basel I relied on the regulatory coordination of Britain and the US, there has been no such regulatory capture in the most recent process. Furthermore, the US has been unable to capture Basel by itself. This is an important finding as it indicates that either there has been a change in the financial regulatory alignment between the US and the UK or that the nature of Basel has somehow changed and regulatory capture is no longer possible. Arguably both of these instances have occurred. These findings point to if not a regulatory competition, then at least significant divergence in the policies governing the banks of the US, Canada, Britain and Germany.

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<sup>408</sup> Atlantic Council (2010): 5

## **7. Conclusion**

Rather than accept the assumptions of neoliberal convergence theory, that globalization in terms of market forces national institutions to converge in regulatory policy, this paper has attempted to reevaluate this claim. Empirically grounded in a detailed study of banking regulation in four countries, the United States, Canada, Britain and Germany, it has been argued that there is divergence in the global regulation of banking.

A better understanding of global trends has been presented by looking at the puzzle through an assessment of national interests, rather than assuming that global market structures overwhelmingly dominate the policies that regulate global banking. Through evaluating these interests we have observed diverging policies in the technical regulations that govern this sector.

This study has conceptualized national bank regulation through the subcategories of policy goals, policy content, policy instruments, and policy styles based on Bennett's definition of policy convergence. Empirics from the four country cases have then been analyzed using Legro and Moravcik's two-step analysis. Comparisons of all these categories indicate divergence in the regulation of banks. This supports the hypothesis that there is divergence in the way that countries regulate banking.

According to the framework of international cooperation, one of the indicators of such diverging behaviour is the evolution of the BCBS. Club international governmental organization affiliation no longer characterizes the coordination of global banking regulation. On the other hand traditions still linger and an attempt has been made to use the existing channels of communications of the BCBS to form some sort of agreement. The lack of discipline in this agreement gives it the potential to be the turning point when regulating global banking evolved from club negotiation to sham standards. Without a credible overarching global regime to draw on, states are left to rely on their own resources.

The void caused by the economic collapse has given both Canada and Europe the opportunity to challenge US financial leadership, however developments are still too premature to evaluate whether this will happen. Based on the predictions given in this study, we should see an increasing competition between influential states.

### ***7.1 Ideas for further research:***

To further evaluate the findings of this study it could be telling to conduct an assessment of whether the new levels for capital requirements, liquidity requirements and leverage standards have any effect on financial stability. Have they corralled problematic banking policies or do they perpetuate the *laissez faire* interests of the banking sector? Finding an answer to this question could shed light on the evolution of sham standards.

It will furthermore be interesting to follow up on the development of competition between influential states. One way of doing this is to assess the complete implementation of Basel agreements when their final phase-in is complete. Such a study should evaluate how intently states are in adhering to these agreements, and how important existing legislative frameworks are in shaping their implementation.



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