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The Political Economy of Post-crisis International Standards for Resolving Financial Institutions

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Abstract

The development of post-crisis international standards for resolving financial institutions highlights an intriguing puzzle: the European Union (EU), which is often considered as a 'great financial power', had a marginal influence in the standard-setting process, which was led by the US and the UK. Why? This paper brings together and further develops the concepts of cross-border externalities derived from the hierarchical network structure of the international financial system and domestic regulatory capacity. The US and the UK had the incentives (externalities) to promote and the domestic capacity to shape international standards. By contrast, the EU was mainly exposed to regional (intra-EU) cross-border externalities and lacked regulatory capacity on the matter. Paradoxically, international standards contributed to developing EU resolution capacity by facilitating an agreement on EU (and later on, euro area) rules.

Keywords: resolution, financial regulation, international standards, post-crisis

1. Introduction

The international financial crisis brought into the spotlight the importance of ‘fit for purpose’ rules for the resolution of financial institutions and the difficulty of cross-border cooperation on this matter. The peak of the crisis was triggered by the badly planned and poorly executed bankruptcy of Lehman Brothers in the United States (US) in October 2008, which sent shock waves throughout the international financial system. For example, the day Lehman Brothers filed for bankruptcy in the US, £3bn of cash was moved from the subsidiary in the United Kingdom (UK) to its parent company in the US. With the parent bankrupt, the London subsidiary had no funding left to pay its staff or its bills (Treanor 2013). In the European Union (EU), the politically acrimonious and economically inefficient rescue of a large cross-border bank, Fortis, demonstrated that even amongst countries with a well-established track-record of economic cooperation, such as the Benelux countries, cross-border resolution could be problematic (see Kudrna 2012). As the Governor of the Bank of England, Mervyn King, pointed out: ‘global banks are international in life, but national in death’ (BBC, 9 March 2009).

Prior to the crisis, there were no international standards for the resolution of financial institutions. After the crisis, international standards were set for the first time ever. The *Key Attributes of Effective Resolution Regimes for Financial Institutions* were issued by the Financial Stability Board (FSB) in 2011 and were designated by the Group of Twenty (G 20) as ‘key international financial standards’, which meant that they would be used by the International Monetary Fund (IMF) and World Bank in their financial services assessment programmes. In 2015, the FSB issued the *Total Loss-Absorbing Capacity (TLAC) standard*

for global systemically important banks (G-SIBs), which complemented the *Key Attributes* and was endorsed by the G 20.

The setting of post-crisis international standards for resolving financial institutions highlights an intriguing puzzle: the EU, which is often considered as a ‘great power’ (Drezner 2007), had marginal influence in the standard-setting process, which was led by the US and the UK. Recent literature on international financial regulation (Bach and Newman 2007; Posner 2009; Muegge 2014; Quaglia 2014a, b; Rixen 2013) considers the EU as a ‘global regulatory force’ that ‘rivals the US in its ability to shape global rules’ (Muegge 2014: 5). Global financial governance is seen as driven by the ‘Euro-American regulatory condominium’ (Posner 2009: 665). Some authors even point out the ‘regulatory imperialism’ of the EU through the ‘worldwide export of European regulatory principles’ (St. Charles 2010: 399) and the EU’s attempt ‘to control the emerging international rule-book’ post-crisis (Moloney 2011: 523). Yet, the EU was a follower, rather than a leader, in international standard-setting on resolution. Why?

In order to shed light on this conundrum, this paper brings together and further develops the concepts of cross-border externalities (Simmons 2001) that derive from the hierarchical network structure of the international financial system (Oatley et al. 2013) and domestic regulatory capacity (Bach and Newman 2007; Posner 2009). It argues that the US (Germain 2016; Ryan and Ziegler 2015) and the UK (James 2015) had an *incentive* to promote international rules because these jurisdictions were heavily exposed to cross-border externalities concerning the resolution of financial institutions – the US and to a lesser extent the UK were the ‘hubs’ of the international financial system. Moreover, the US and the UK had the *capabilities* to shape international standards because post-crisis these jurisdictions

substantially developed their domestic ‘regulatory capacity’ on resolution. In so doing, they developed regulatory templates (especially, instruments and strategies) and expertise that could be utilised in international standard-setting. By contrast, the EU had fewer *incentives* and lacked the *capability* to shape international standards on resolution. The EU (and its member states, except the UK) was mainly exposed to intra-EU cross-border externalities (especially in the euro area), and lacked regulatory capacity on resolution. After the crisis, the EU had an incentive to develop its own regional rules on resolution, but that proved to be difficult because EU capacity had to be built from scratch in the face of considerable intra-EU disagreements. Paradoxically, international standards on resolution eventually contributed to developing EU resolution capacity, facilitating an agreement on EU (and later on, euro area) rules.

This paper first reviews the literature on international standard-setting in finance and outlines the explanation put forward in this paper. It then discusses the most innovative instruments and strategies in the post-crisis reform of resolution. The externalities and the developments of post-crisis resolution capacity in the US and the UK are then examined, followed by the discussion of the post-crisis international standard-setting process. The seventh section examines the intra-EU cross-border externalities and the piecemeal building-up of EU resolution capacity after the crisis. The penultimate section briefly considers the limited externalities and regulatory capacity of other major jurisdictions, namely China and Japan.

2. Explaining international standard-setting in finance

The literature on international regulatory cooperation in finance is vast. This section reviews two main bodies of literature that explain why and how jurisdictions engage in international

standard-setting in finance, pointing out the limitations and the blind-spots of these accounts. It also outlines how these explanations can be fruitfully combined. This is followed by a discussion of works that highlight the influence of the financial industry in the standard-setting process and which can be seen as providing an alternative explanation to state-centred accounts.

A body of scholarly works explains why jurisdictions engage in international regulatory cooperation in finance on the basis of its redistributive implications. The power of jurisdictions derives from their domestic market size, or the network structure of the international financial system. The early literature stresses the ‘hegemonic’ power of the US in finance, contending that international harmonisation reflects the interplay between the externalities of the main jurisdiction (namely, the US) and the incentives of other jurisdictions to emulate the rules of the dominant financial centre (Simmons 2001). Subsequent work examines not only the US, but also the UK and Japan, arguing that these jurisdictions engage in international standard-setting to restore the domestic balance between competition and stability in response to an external shock (Singer 2007: 11). Other works bring a regional jurisdiction, the EU, into the picture. Drezner (2007: 8) posits that the US and the EU are ‘great powers’ because their massive market-size enables them to shape international standards on the basis of expected domestic adjustment costs. Rixen (2013) points out that international regulatory cooperation is difficult because various jurisdictions engage in ‘regulatory competition’, whereby national politicians play a ‘two-level game’ between their domestic electorate and international finance.

Recent work draws attention to the persistence of US hegemony, whose power derives not so much from its domestic market, but rather from the hierarchical network structure of the

international financial system. The US and to a lesser extent the UK have a high degree of centrality in the network because they are the most interconnected centres (Oatley et al. 2013).¹ With reference to the resolution of cross-border financial institutions, the negative externalities deriving from the hierarchical network structure are particularly high for jurisdictions, such as the US and the UK, which are ‘home’ of and ‘host’ to a large number of cross-border banks, especially globally systematically important banks (G-SIBs). Hence, the first building block of the explanation put forward in this paper is that jurisdictions that are home and host to a large number of G-SIBs and have a high level of foreign bank penetration will promote international standards on resolution (and vice versa). This explanation sheds light onto why jurisdictions promote (or not) international regulatory cooperation in finance, but is less well equipped to explain how jurisdictions are able to do so, that is to say, how they shape international standards and what informs the specific content of these rules.

A second body of scholarly work on international regulatory cooperation considers how domestic institutions affect the preferences and power of jurisdictions, drawing attention to ‘domestic regulatory capacity’, defined as ‘a jurisdiction’s ability to formulate, monitor, and enforce a set of market rules’ (Bach and Newman 2007: 831). Bach and Newman (2007: 828) claim that ‘regulatory state institutions translate latent power vested in the domestic market into concrete international influence’. Posner (2009) argues that the ‘centralisation of rule-making’ in the EU accounts for its ability to settle financial disputes with the US on satisfactory terms. Moreover, the sequencing in the development of domestic regulatory capacity of various jurisdictions provides ‘first mover advantages’ (Posner 2010). Quaglia (2014a,b) examines the development of regulatory capacity in the US and the EU in order to explain the ‘uploading, downloading and cross loading’ of international financial regulation.

Domestic regulatory capacity can be influential in international standard-setting in several ways, besides regulatory centralisation (Posner 2009) and the ability of a jurisdiction to set the terms of access to its domestic market (Bach and Newman 2007). First, domestic regulatory capacity enables jurisdictions develop regulatory templates (including instruments and strategies) that can be projected internationally and be used to inform international standards, especially if such standards have to be written from scratch, as it was indeed the case for resolution. Secondly, domestic regulatory capacity allows the building-up of technical expertise and human resources, which can then be deployed in international standard-setting. For example, the Bank of England put some of its best minds to work on post-crisis resolution. Third, domestic regulatory capacity enables policy-makers from the same jurisdiction to ‘read from the same script’ when international standards are negotiated, avoiding disjointed positions. This quest for cohesiveness is particularly challenging for the EU, which is a regional jurisdiction in which the member states often have different preferences and are active players in their own right in international fora.

Regulatory capacity is the second building block of the explanation articulated in this paper. It explains how jurisdictions shape international standards, but it overlooks the incentives that jurisdictions have (or not) to promote international standards. There are several areas of financial regulation in which the main jurisdictions have domestic regulatory capacity and a ‘first mover advantage’, but do not engage in international standard setting. Some recent examples are the rules on bank structure, whereby the so-called ‘Volcker rule’ in the Dodd-Frank Act in the US (Ryan and Ziegler 2015) and the ‘ring-fencing’ eventually adopted by the UK authorities (Bell and Hindmoor 2015; Scott 2015) were not followed or accompanied by the attempt of US and UK policy-makers to set international standards on this matter. Other times, the exact sequencing is hard to chart because of the interactive process between

international and domestic regulatory changes, hence there are ‘policy feedbacks’ (Newman and Posner 2016) deriving from international standards.

The explanation put forward in this paper combines and further develops the concepts of cross-border externalities deriving from the hierarchical network structure of the financial system and regulatory capacity of the financial great powers, namely the US, and the EU: externalities provide the incentive to promote international standards, regulatory capacity enables jurisdictions to shape those standards. This two-fold explanation is operationalised in several complementary ways. The following sections present empirical evidence concerning: i) the distribution of G-SIBs and the degree of foreign bank penetration in the US, the EU and within it, the UK, France and Germany, which are the main EU member states; ii) the domestic and international activities of the US and the UK policy-makers to promote international standards; iii) the limited involvement of EU, French and German policy-makers in international standard-setting and the EU’s piecemeal attempt to set ‘regional’ rules after the crisis ; iv) regulatory templates (instruments, strategies etc.) sponsored by US and UK policy-makers in the making of international standards; v) regulatory templates included in international standards and subsequently adopted (‘downloaded’) by the EU. The sources used are policy documents, speeches of policy-makers, a systematic survey of press coverage and semi-structured elite interviews with policy-makers. In the text, publicly available sources are cited whenever they confirm points made during interviews.

The main alternative explanation to state-centric accounts stresses the power of the financial industry, especially big transnational banks, in shaping international financial standards (Baker 2010; Tsingou 2008, 2015; Underhill and Zhang 2008). For example, Lall (2012: 7, cf Young 2012) argues that Basel II and Basel III were the result of ‘regulatory capture’ (see

also Underhill and Zhang 2008). In the case of resolution, the financial industry was somewhat less engaged in the international regulatory debate. For example, the BCBS received about 250 industry response to the consultation on Basel III in 2010, whereas the FSB received 60 industry responses to the consultation on resolution in 2011. National banking associations and individual G-SIBs were by and large supportive of international standards as suggested, for example, by the responses to the FSB's consultation (see, *inter alia*, the British Bankers Association, the French Banking Association, the European Banking Federation).²

The Institute of International Finance (IIF), which mainly represents large cross-border financial institutions, argued in favour of an 'international framework for the resolution of cross-border financial institutions', the 'convergence toward credible national regimes, strong coordination among resolution authorities, good institution-specific cooperation agreements, and equitable cross-border outcomes on a non-discriminatory basis' (IIF 2011: 1). The IIF issued a handful of documents on this matter (see, for example, IIF 2010), even though the main document was issued after the FSB's *Key Attributes* had been agreed (IIF 2012). Carstensen (2013a) posits that large cross-border banks and the IIF supported resolution rules as an alternative to bank structural reforms and to the financial market fragmentation that would have resulted from subsidiarisation, which was an alternative solution to deal with cross-border bank failures, as suggested for example, by the so-called 'Turner review' (FSA 2009).

The industry-based explanation complements the state-centric explanation provided by this paper: the international financial industry was aware of the need reform resolution rules and the need to do so in a coordinated way across jurisdictions to avoid extra-costs for cross-

border business. Hence, the financial industry was broadly supportive of resolution rules issued by international standard-setting bodies under the aegis of the US and the UK. However, the industry was not the main driver of the process and did not propose any of the new instruments and strategies (discussed below) that informed the post-crisis reform of resolution. On the contrary, the IIF was cautious concerning the instrument of the bail-in, arguing that the ‘bailing-in of unsecured senior debt should occur only in special circumstances’ (IIF 2011: ii, 19-20). It was also agnostic about the use of the single or multiple point of entry resolution strategies (IIF 2012: 36).

3. Key post-crisis instruments and strategies for resolving financial institutions

Resolution is the process by which the authorities intervene to manage the failure of a firm. The main objective in the resolution of financial institutions is to ensure that they can fail in an orderly fashion — that is, without excessive disruption to the financial system, without interruption to the critical economic functions that these firms provide,³ and without exposing taxpayers to losses deriving from public bailouts (FSB 2011). Although the reform of resolution was not a paradigmatic shift or a ‘gestalt flip’ as in the case, for example, of macroprudential supervision (see Baker 2013), three new inter-related instruments and strategies informed the post-crisis reform of resolution.

First, the ‘*bail-in*’, which was defined by the Deputy Governor for Financial Stability at the Bank of England, Paul Tucker (2013a: 6), as ‘nothing short of a revolution in thinking about the resolution of large banks’. It gives the resolution authorities the statutory power to write-off equities and write-down or convert debt into equities as a means of recapitalising an ailing institution (FSB 2011). The bondholders become the new shareholders, the previous

shareholders lose their investment and culpable management exit. In the bail-in, the distressed financial institution is restored to viability ('going concern') through the restructuring of its liabilities and without the injection of public funds, as occurs in the bail-out (Tucker 2013b). Whereas prior to the crisis debt restructuring and write down were mostly done with the consent of the creditors, the bail-in gives the authorities the statutory power to restructure the liabilities of ailing financial institutions. Moreover, the bail-in can be used (and many regulators argue that it *should* be used) while an ailing financial institution is still a going concern. Hence, bail-in can (or *should*) be used to avoid liquidation. Finally, the bail-in also involves uninsured depositors for the amount above the threshold set by the deposit guarantee schemes (as in the case of Cyprus).

The instrument of bail-in was mainly developed by the UK, to be precise by the Bank of England (see Tucker 2010, 2012; Gracie 2012). It had the support of the US, first and foremost the Federal Deposit Insurance Corporation (FDIC) (Bank of England and FDIC 2012), especially once the bail-in was linked to the FDIC's preferred resolution strategy, as explained below. It should be noted that Denmark established a short-lived bail-in scheme to unwind ailing banks in 2010. The experiment, which quickly backfired because investors became reluctant to lend to Danish banks (Carstensen 2013b), suggested that the adoption of the bail-in only in only one country was not an option because it would penalise its banks. To be effective, the instrument of the bail-in had to be prescribed by international rules applicable to jurisdictions worldwide.

The second innovative instrument in the post-crisis debate on resolution is the '*loss absorbing capacity*' (LAC), which gained momentum once the new instrument of the bail-in was outlined and the debate on resolution strategies was underway. Indeed, the bail-in

requires that top holding company and/or the top entities in the subgroups have a critical mass of bonds that can be ‘bailed-in’, contributing to the LAC. The main sponsors of the LAC were the US authorities (see Federal Reserve, the FDIC and the Office for the Comptroller of the Currency 2010), especially the Federal Reserve (Tarullo 2012; Gibson 2013), and the UK authorities, particularly the Bank of England (Gracie 2014), which were dissatisfied with the national implementation (effectively, the ‘watering down’) of the Basel III accord that set international capital and liquidity standards.⁴ International rules on the LAC were needed to make the ‘liability structures’ of G-SIBs ‘compatible with resolution and time-consistent in a cross-border context’ (Gracie 2014: 783).

As for post-crisis resolution strategies for cross-border groups, the ‘*Single Point of Entry*’ (SPE) and the ‘*Multiple Point of Entry*’ (MPE) were put forward, whereas prior to the crisis resolution had mostly been carried out along national lines, according to a ‘territorial’ approach. The SPE gives the home resolution authorities the lead in resolution; losses are managed at the parent (holding company) level. Shareholders and creditors of the holding company absorb the losses of the entire group through the ‘bail-in’ and the capital acquired in this way is then distributed to subsidiaries (IMF 2010). The SPE satisfactorily protects the interests of the home authorities, which are in charge of the process, but is less appealing for hosts, as it assumes that the latter trust and cooperate with the former. The SPE was developed by the US, to be precise by the FDIC (Gruenberg 2013; Wigand 2012), with the support of the Federal Reserve (Tarullo 2013), and was endorsed by the UK, notably the Bank of England (Bank of England and FDIC 2012; Tucker 2013). The alternative strategy, the ‘Multiple Points of Entry’ (MPE), shares resolution powers between the home and host authorities; losses are managed at the level of the parent and the sub-groups of subsidiaries. These subgroups are resolved in separate proceedings by the respective resolution authorities.

The MPE is suitable if the sub-groups of subsidiaries can operate on a stand-alone basis (IMF 2010). International rules concerning resolution strategies were needed to encourage jurisdictions worldwide to adopt domestic rules that would make these strategies, especially the SPE, feasible across borders.

4. Strong externalities and resolution capacity in the US

The US is the jurisdiction most exposed to negative cross-border externalities concerning the resolution of financial institutions. Therefore, US policy-makers had a significant incentive to develop international standards on the matter. The US is home to the largest number of G-SIBs (eight in total) and foreign bank penetration averages 30% in the US. As pointed out by the member of the Board of Governors of the US Federal Reserve Daniel Tarullo (2013) ‘very large financial firms... have extensive cross-border activities, and thus implicate the legal systems of other countries’. This meant that the post-crisis domestic reform of the resolution regime in the US was necessary but not sufficient to solve the problem of financial institutions ‘too big to fail’. Similar resolution rules needed to be adopted across jurisdictions and international standards were instrumental to that end. The promotion of international standards on resolution by US policy-makers can be gauged by: the large number of speeches and documents issued on this matter; the chairing of key committees or working groups in international standard-setting bodies (discussed in the section after next); the accounts given by policy-makers from within and without the US; and the fact that the instruments and strategies (the LAC, the SPE, but also resolution plans, stay on derivatives) sponsored by US policy-makers were adopted as international standards.

The considerable domestic regulatory capacity on resolution enabled the US to shape the content of international standards. After the crisis, the US developed a special resolution regime for ‘Systemically Important Financial Institutions’ (SIFIs) through the ‘Dodd-Frank Wall Street Reform and Consumer Protection Act’ in July 2010 (Germain 2016; Ryan and Ziegler 2015; Wooley and Ziegler 2012). SIFIs were required to submit recovery and resolution plans, to be jointly reviewed by the FDIC and the Federal Reserve, which had the power to require changes concerning the structure of financial institutions in order to improve their resolvability. The Act extended the FDIC’s resolution powers to all SIFIs through the creation of an ‘Orderly Liquidation Authority’ and required that the losses of ailing financial institutions should not be borne by taxpayers, but by shareholders and unsecured creditors.

The US authorities claim that the Orderly Liquidation Authority was a ‘model resolution regime for the international community’ and that the core features of the FSB’s *Key Attributes of Effective Resolution Regimes for Financial Institutions* issued in 2011 were already embodied in Orderly Liquidation Authority (Tarullo 2013). ‘By acting early through the passage of the Dodd-Frank Act, Congress paved the way for the United States to be a leader in shaping the development of international policy for effective resolution regimes for systemic financial firms’ (Gibson 2013: 3). This statement is corroborated by the fact that the underlying approach to resolution adopted by the FSB (2011), which forbade the use of public funding to bail-out banks and argued instead that shareholders and creditors should take losses, was in line with the resolution objectives of the Dodd Frank Act. Moreover, many instruments listed in the Dodd Frank Act were included in the FSB’s *Key Attributes*, notably the recovery and resolution plans and the stay provision for derivatives. Furthermore, the resolution strategy developed by US regulators as part of the enacting rules of the Dodd-Frank Act, the SPE, was included in the *Key Attributes*.

The FDIC and the Federal Reserve (Tarullo 2013) supported the SPE strategy, which was well suited to the structure of large US financial groups where the top-tier parent company generally was a holding company, whose primary purpose was to raise capital and direct the operations of its subsidiaries. The UK authorities joined the US authorities in promoting bilaterally and internationally the SPE because many UK banks were organized with a holding company at the top. In turn, US senior officials warmed up to the bail-in because it fit well with their preferred resolution strategy, the SPE, whereby bail-in would be applied at the top holding company level. However, that required sufficient LAC, that is, debt that could easily be bailed in. Therefore, as elaborated below, the US and the UK authorities promoted an international standard on this matter, which was eventually adopted by the FSB in 2015 (FSB 2015). Domestically, the Federal Reserve proposed LAC rules for the US G-SIBs in October 2015, before the FSB's standard was issued, and the two sets of rules were largely in line.

5. Strong externalities and resolution capacity in the UK

The UK is heavily exposed to international negative cross-border externalities concerning the resolution of financial institutions: it is home to four G-SIBs and about 40 per cent of the banking sector is foreign owned, the majority by non-EU (mostly US) banks. For UK policy-makers, a crucial problem was 'how to resolve UK banks that operate with branches or subsidiaries in other countries, and likewise how foreign banks operating in the UK' (Bailey 2009: 6). Therefore, UK policy-makers had a significant incentive to develop international standards on resolution, as suggested by the large number of speeches and documents they issued on this matter; the chairing of key international committees; the

accounts provided by policy-makers; and the fact that instruments and strategies (the bail-in, the LAC, the SPE) sponsored by the UK policy-makers were adopted as international standards.

The domestic regulatory capacity that the UK developed on resolution after the crisis gave this jurisdiction an extra-edge in shaping the content of international standards. The Banking Act (2009) established within the Bank of England a special resolution authority with a vast array of resolution powers. The Special Resolution Unit was headed by Andrew Gracie and reported to the Deputy Governor for Financial Stability Paul Tucker. The Bank of England also began working in earnest on new instruments and strategies for resolution. The concept of bail-in, which was initially put forward by two senior economists of Credit Suisse in an article in *The Economist* (Calello and Ervin 2010), immediately gained traction at the Bank of England because the ‘traditional’ way to resolve banks was seen as unsuitable for large cross-border banks, especially G-SIBs. In the summer of 2010 senior officials at the Bank of England argued that the bail-in should be considered as a resolution instrument (Bailey 2010). Well before the FSB included the bail-in in the *Key Attributes*, the Financial Stability Report of the Bank of England stated that the bail-in should be extended to other potentially systemic institutions (Bank of England 2010). The Bank also supported international rules on the LAC, which were needed in order to make bail-in possible in practice (Gracie 2014: 783). The Independent Commission on Banking Commission (2011) recommended a LAC of at least 17%-20%, which was broadly in line with the standard subsequently set by the FSB in 2015.

In December 2012, the Bank of England and the FDIC released a joint paper on ‘Resolving Globally Active, Systemically Important, Financial Institutions’. This bilateral document was

of general relevance because it explicitly stated that it was an exercise in implementing some aspects of new international standards on resolution issued by the FSB in 2011, discussed in the following section. The joint paper set out a framework for the application of the SPE strategy for resolving a US or UK financial group. Nearly 70 percent of the on- and off-balance sheet assets of the major US financial institutions are held in the UK (Gruenberg 2013).

6. Post-crisis international standard-setting on resolution

The main international body involved in international standard-setting on resolution was the FSB, with contributions from the BCBS. For example, in 2010, the BCBS issued the *Recommendations of the Cross-Border Bank Resolution Group*, which were designed to inform the reform of national resolution and bankruptcy law. The FSB produced several documents between 2009 and 2011. Eventually, the FSB issued the *Key Attributes of Effective Resolution Regimes for Financial Institutions* (2011),⁵ which were designed to be implemented by the member jurisdictions in the reform of domestic resolution laws. The *Key Attributes* included amongst preventive instruments, recovery and resolution plans and amongst resolution instruments, the bail-in and the LAC. International resolution colleges were to be set up. Although the *Key Attributes* listed both the SPE and MPE as suitable resolution strategies, it is noteworthy that the international standards contained provisions that were instrumental to put into effect the SPE.

The US and the UK authorities were the main advocates of the SPE. US G-SIBs had a configuration suitable for the SPE strategy and so did the UK banks, with the notable exception of the HSBC. Spanish G-SIBs (BBVA and Santander), given their extensive retails

operation in Latin America, had a configuration suitable for the MPE strategy. Hence, the Spanish authorities were the main advocates of the MPE, as argued, for example, by the Governor of the Banco de España (Linde 2013). French banks and French policy-makers favoured the SPE (Autorité de Contrôle Prudentiel et de Résolution 2013). Germany had only one G-SIB, the Deutsche Bank, which had a SPE configuration. Thus, for the UK, France and Germany the SPE strategy was acceptable (less so for other EU countries, such as Spain). At any rate, many SPE groups outside the US would have to adapt their structure by establishing holding companies from which to issue bonds that could absorb losses (Tucker 2013).

Subsequently, the FSB's work, with the collaboration of the BCBS, focused on the level and the distribution of the LAC for the bail-in. Standards on the LAC were advocated by the US banking regulators (see joint statement by the Federal Reserve, the FDIC and the Office for the Comptroller of the Currency 2010), the Independent Commission on Banking (2011) and the Bank of England (e.g. Gracie 2012). By contrast, the EU was silent on the matter. In November 2015, the FSB issued the *Total Loss-Absorbing Capacity (TLAC) standard for global systemically important banks (G-SIBs)*. The rationale underpinning this standard was to ensure a sufficient level of LAC at the right level of the financial group, depending on the resolution strategy chosen (SPE or MPE).

In the FSB, the most influential officials were those from the US and the UK, which chaired key committees (interview, Washington, July 2012; Brussels, September 2013). For example, from 2007 onwards, the FDIC co-chaired with the Swiss supervisory authority the Cross-Border Bank Resolution Group of the BCBS, which produced a key report in 2009. The Federal Reserve Bank of New York chaired the FSB's Crisis Management Group (Ryan and Ziegler 2015). As for the UK, Deputy Governor Paul Tucker chaired the FSB Resolution

Steering Group and the Basel Committee on Payment and Settlement Systems and was co-chair of the Steering Group established jointly by the Committee on Payments and Settlements Systems and the International Organisation of Securities Commissions. The head of the UK Financial Services Authority (before it was disbanded), Lord Adair Turner, chaired the FSB Standing Committee on Supervisory and Regulatory Cooperation and led the FSB's work on tightening regulation of the shadow banking sector. The Governor of the Bank of England, Mark Carney, who was appointed in 2013, had chaired FSB since 2011 (James 2015). The FDIC, the Federal Reserve and the Bank of England invested considerable resources in the policy debate on resolution, as suggested by the many documents they issued and the numerous speeches that they made on this topic - there was no equivalent for the EU.

The EU was represented in the FSB by the European Central Bank (ECB) and the European Commission, neither of which had legal competences or expertise on resolution and supervision (the ECB acquired supervisory competences in 2014). Six EU member states were represented by their respective national authorities, but they had different views on resolution (interview, Brussels, September 2013). Since the EU lacked regulatory capacity on resolution, there was no EU legislation to which the EU authorities and the member states could make reference so as to speak from the same script. The European Commission, the ECB and the member states mainly focused on the intra-EU debate concerning the adoption of EU legislation. As one policy-maker put it, 'we had enough on our plate with that' (interview, Brussels, September 2013). That is not to say that the EU was oblivious of the international debate. Reportedly, the European Commission, which was preparing EU legislation on the matter, closely followed the FSB's work.

7. Intra-EU externalities and piecemeal building-up of EU resolution capacity

The EU is primarily exposed to intra-EU cross-border externalities concerning the resolution of ailing banks. On the one hand, the EU as a whole is ‘home’ to a large number of G-SIBs and has a high level of cross-border banking by ‘smaller’ banks (i.e. non G-SIBs). On the other hand, the cross-border activities of EU banks, including G-SIBs, primarily take place *within* the EU. Although the levels of foreign bank penetration in the EU as a whole is below 30%, hence not too dissimilar from the US, foreign penetration by non-EU banks is below 10% (the UK is an exception) (Schoenmaker 2013: 48). Moreover, Germany and France have the lowest degree of foreign bank penetration in the EU (Howarth and Quaglia 2016). Individual member states, some of which are represented in international standard-setting bodies, are home to only one G-SIB or have no G-SIB. The only exceptions are France, which has four G-SIBs and Spain, which has two G-SIBs. However, most French G-SIBs mainly operate within the EU.

Given the high level of cross-border banking in the EU, this jurisdiction had an incentive to develop post-crisis EU rules on resolution, rather than international standards. An EU resolution regime became even more urgent after the worsening of the sovereign debt crisis in the euro area, which triggered the so-called ‘doom loop’ between ailing banks and fiscally-weak sovereigns. The limited contribution of EU and national policy-makers from continental Europe to international standard-setting on resolution is suggested by: the few speeches or policy documents that made reference to the need for international regulatory cooperation on the matter; the accounts provided by policy-makers; the lack of specific instruments or strategies uploaded or promoted by the EU and continental member states; the priority given to the development of EU rules.

There are very few speeches of the European Commission calling for international standards on resolution, albeit the Commission was very active in the intra-EU debate, first and foremost in the preparation of EU legislation. At the national level, whereas the UK authorities were very vocal about the need to reform resolution regimes and set international rules, that was not the case in France and Germany. Over the period 2009-11, senior officials at the Bank of England gave dozens of speeches on resolution. By contrast, senior officials at the Banque de France did not mention the need to reform resolution either domestically or internationally. Senior officials at the Bundesbank pointed out the need for new rules on resolution in a handful of speeches, but they did not promote any of the new instruments and strategies that drove the reform of post crisis resolution. Moreover, German policy-makers, like other continental policy-makers, prioritised the development of EU rules to international ones (Dombret 2011).

At the national level, France did not reform its resolution regime in the aftermath of the crisis, thus this jurisdiction did not develop new instruments or strategies that could be deployed in international standard-setting. The resolution regime in France was reformed only in 2013, following the domestic implementation of EU legislation. In Germany, the Bank Restructuring Act (2010) set in place a two-stage recovery and reorganisation procedure and established a Bank Restructuring Fund with levies paid by banks (see Goldbach and Zimmermann 2015). However, the German reform did not include any of the key instruments or strategies (bail-in, SPE, the LAC) that were later included in the international standards on resolution (the FSB's *Key Attributes*). On the contrary, the German authorities initially expressed cautious views about the bail-in, arguing that the bail-in should 'be strictly limited to circumstances in which the application of alternative resolution methods is impractical and

would have adverse effects on the stability of the financial system’ (German Finance Ministry and Ministry of Justice 2011). Germany became the main supporter of the bail-in in the EU once the Bank Recovery and Resolution directive (BRRD) was officially proposed by the Commission and linked to the negotiations on the Single Resolution Mechanism regulation, after the worsening of the sovereign debt crisis in the euro area.

Prior to the crisis, the EU lacked regulatory capacity on resolution (Kudrna 2012; Pauly 2008), which was a sensitive matter for the member states, given its potential fiscal implications that could impinge upon national sovereignty. Moreover, the national resolution regimes of the member states pursued different goals, prescribed the use of different tools and gave the competent authorities different powers. Resolution powers were allocated to different domestic authorities in the member states (see CEBS 2008). The EU developed resolution capacity from scratch after international standards were set, which considerably reduced the EU’s influence in the standard-setting process. In fact, the EU downloaded international standards that were the starting point for the EU resolution regime. The Preamble of the BRRD openly stated that the directive incorporated and further expanded the *Key Attributes* issued by the FSB.

In the wake of the crisis, the de Larosière report (2009: 34) argued that ‘the lack of consistent crisis management and resolution tools across the Single Market places Europe at a disadvantage vis-à-vis the US and these issues should be addressed by the adoption at EU level of adequate measures’. The European Commission published a document for public consultation as early as 2009 (Commission 2009). A second public consultation followed in 2011 (Commission 2011). The summary of the responses to consultations concluded that ‘the creation of an international legal framework should be *preceded* by harmonization of EU

rules’ (Commission 2011, *emphasis* added). However, the consultations also revealed profound intra-EU divisions and therefore no official proposal for legislation was put forward by the Commission until 2012, after the FSB’s *Key Attributes* were issued in 2011.

The BRRD eventually agreed in 2014 set new preventive instruments, first and foremost recovery and resolution plans, which had already been introduced in the US and the UK (2010, 2009), and were prescribed by the FSB’s *Key Attributes* (2011). European resolution colleges were established, mirroring the international resolution colleges set up by the *Key Attributes*. The most innovative resolution instruments envisaged by the BRRD were the bail-in and the LAC, as prescribed by the *Key Attributes* of the FSB. As for resolution strategies, the BRRD discussed the SPE and the MPE. The BRRD was adopted together with the Regulation of the Single Resolution Mechanism (2014) for the euro area, where financial interpenetration was particularly high (see Howarth and Quaglia 2016). It is beyond the scope of this paper to discuss the Single Resolution Mechanism, which is one of the key elements of Banking Union. Here it is important to point out that the bail-in was instrumental in reaching a euro area agreement because it reduced substantially the need for public funding to bail out banks.

8. Other large jurisdictions

What about other jurisdictions, namely China and Japan, which have large banking sectors, albeit not as large as the ones in the US and the EU? In China a large share of the banking sector is state-owned. China has two G-SIBs in the group of ‘smaller’ G-SIBs and when the FSB were agreed in 2011 China had only one G-SIB (FSB 2012). China has a low level of foreign bank penetration, approximately 5% (measured as lending by foreign banks to non-

banks as a percentage of total bank lending in China) and the limited activities of Chinese banks abroad account for less than 5% of the total bank assets of Chinese banks (Schoenmaker 2013). Hence, China has low resolution externalities deriving from cross-border banking.

Domestic regulatory capacity on resolution was minimal in China, which lacked a resolution regime and an explicit deposit insurance system (IMF 2011). Furthermore, China joined the FSB in 2010 and needed a ‘bedding in’ period. Hence, it displayed a limited involvement in standard-setting in the early years after joining the FSB (interview, Beijing, June 2012). This is confirmed by the annual Financial Stability Reports of the People’s Bank of China which demonstrate a focus on ‘downloading’ and implementing the latest international standards (see People’s Bank of China Financial Stability Report 2015: 137-141). As Foot and Walter (2011: 264) point out, Chinese officials saw advantages in the ‘importation of financial regulatory and managerial “technology” from the advanced countries’ through the Basel framework.

Japan has three G-SIBs in the groups of the ‘smaller’ G-SIBs (FSB 2012) and has limited foreign bank penetration, approximately 5% (Schoenmaker 2013: 48). Hence, Japan has limited externalities deriving from the resolution of cross-border banks. Moreover, Japan had limited domestic regulatory capacity on resolution because Japanese legislation on the matter was not revised in the wake of the international financial crisis. There is no evidence of domestic regulatory templates (instruments, strategies) uploaded by the Japanese authorities to international standards. On the contrary, the IMF (2012) recommended that Japan should revise its resolution regime so as to incorporate the FSB’s *Key Attributes*. In 2013, the ‘Orderly Resolution Regime’ adopted in Japan introduced new resolution instruments, such

as the bail-in, the temporary stay on derivatives, and recovery and resolution plans (Kodachi 2013).

9. Conclusion

This paper has argued that the US and the UK have led the international standard-setting process on resolution and have shaped the content of the new rules. Their incentive to do so resulted from the cross-border externalities related to the resolution of financial institutions, especially G-SIBs. Their ability to do so resulted from the resolution capacity that the US and the UK developed in the wake of the crisis. The US and the UK sponsored new instruments and strategies, namely the bail-in, the LAC and the SPE, and deployed highly-regarded top officials, such as Gruenberg, Tarullo, Tucker, Gibson, Bailey, Gracie and Wigand, who moved the international debate forwards. By contrast, the EU was primarily exposed to intra-EU externalities, given the high level of financial integration in the EU, especially in the euro area, as revealed by the sovereign debt crisis. The EU lacked pre-crisis resolution capacity and post-crisis it struggled to develop its own resolution regime, which was adopted as late as 2014, after the FSB's *Key Attributes* had been set. These international standards contributed to forge an EU agreement and a euro area agreement on new regional resolution rules. Hence, the new instruments and strategies set by the *Key Attributes* subsequently fed into the EU and euro area resolution capacity.

Theoretically, this paper draws attention to cross-border externalities derived from the networked structure of the international financial system, distinguishing between international and regional (intra-EU) externalities, which give the great financial powers incentives to promote international or regional rules. The externalities of the US and UK

stem for their dominant position in global banking networks. By contrast, there is a relative dearth of EU interconnections globally, but there are strong intra-EU interconnections (especially the euro area) - that is where the action of EU and European policy-makers focused. From this point of view, the UK had an intermediary role between global and European banking networks. Indeed, most US investment banks (but also insurers, e.g. AIG) enter the EU single financial market via London and most big continental banks have a strong presence in London. This paper also highlights how domestic regulatory capacity enables jurisdictions to shape international standards, albeit not in the same way pointed out in the literature so far. Regulatory capacity allows jurisdictions to develop regulatory templates (especially, new instruments and strategies) and expertise that can be purposely deployed in international standard-setting. In turn, international standards have policy-feedbacks (Newman and Posner 2016) on domestic regulatory capacity because they can be instrumental in furthering agreement between different domestic players, especially in a regional jurisdiction, such as the EU.

Although this explanation is mainly rooted in the international political economy literature, it also speaks to scholarly works in comparative political economy.⁶ It sheds light on how domestic reforms, which are embedded in national varieties of capitalism, contribute to shape international rules (Fioretos 2010). International standards on resolution were needed to complement domestic regulatory reforms in jurisdictions, such as the US and the UK, that were highly interconnected globally. In these jurisdictions, new post-crisis domestic resolution rules were *necessary* but not *sufficient*. In order to be effective, domestic rules had to be matched by similar (or at least, compatible) rules in interconnected jurisdictions - international standards were instrumental to that end. The findings also suggest that US and UK liberal banking systems – which are the hubs of the international financial system - have

a tendency to upload regulatory preferences to the international level. Continental banking systems, particularly in France and Germany, often download financial standards.

Standard-setting on resolution was overall consensual. The financial industry did not oppose international standards and G-SIBs and the IIF openly supported these rules that would facilitate their cross-border activities. The EU supported international standards because it was exposed to negative cross-border externalities deriving from third-country banks operating in the EU and vice versa, albeit less than the US and the UK. China and Japan had no reason to oppose international standards that would apply only to a couple of their banks. Moreover, the US and UK authorities made clear that if international standards were not set, these jurisdictions would require foreign banks to operate as self-standing subsidiaries (interviews, Washington, July 2012). This begs the question of what happens if there are veto players, that is, if one (or more) major jurisdictions or large parts of the financial industry oppose international standards.

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² http://www.fsb.org/2011/09/c_110909/

³ Examples of critical economic functions include: payments; clearing and settlement; custody services; etc.

⁴ This point was made very forcefully during an event in Brussels attended by the author under the ‘Chatham house rule’ in 2014.

⁵ The Key Attributes were subsequently revised in 2014, when additional guidelines for non-bank financial institutions were added as annexes.

⁶ I wish to thank a review for this point.

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