The politics of state compliance with international “soft law” in finance

The Politics of State Compliance with International 'Soft Law' in Finance

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Abstract

Why do jurisdictions comply (or not) with international soft law in finance? This research systematically links international and domestic explanations of compliance by highlighting the 'disjuncture' between the standard-setting process at the international level and the process of compliance at the domestic level. Two causal mechanisms that affect compliance are identified. In the first stage, elected officials de facto delegate the making of international soft law to domestic regulators; large, internationally-active financial institutions mobilize extensively and, to a large extent, successfully. In the second stage, domestic interest groups team up with elected officials in order to resist compliance with international soft law that has negative distributional implications for domestic constituencies. These arguments are illustrated through a structured, focused comparison and process-tracing of the mixed record of compliance of the two main jurisdictions worldwide – the United States and the European Union – with the main international banking standards, the Basel Accords.

1. Introduction

Over the last decades there has been a substantial expansion of international regulation in the form of 'international informal law', or 'soft law' (Abbott et al., 2000). Most of these standards are issued by transgovernmental networks of national regulators (see, inter alia, Bach & Newman, 2014; Büthe and Mattli, 2011; Drezner, 2007; Mattli and Woods, 2009) and become legally binding only if they are implemented by individual jurisdictions according to their domestic rule-making processes. Compliance with international soft law is particularly important in finance because many new (or substantially revised) standards were adopted by transgovernmental networks after the international financial crisis (Fioretos, 2010; Goldbach, 2015; Lall, 2012; Tsingou, 2010; Young, 2012). Yet, if jurisdictions do not comply with these standards, they become a dead letter.

There are different ways of operationalising compliance with international soft law: i) the domestic authorities adopt domestic regulation (legislation and agency rules) that gives legal effect to international standards; ii) the domestic authorities enforce the domestic regulation that gives effect to international standards; iii) private actors act according to international standards. This research examines the first type of compliance, namely, state compliance, because it generates an interesting empirical puzzle. Large jurisdictions, which have a significant influence on the development of international soft law (Drezner, 2007; Büthe and Mattli, 2011), especially in finance (Fioretos, 2010; Posner, 2010; Simmons, 2001), sometimes do not comply with those standards. Why?

The main international financial standards are the Basel Accords that set capital requirements for internationally active banks. Basel II was not implemented in the United States (US) prior

to the international financial crisis, despite the fact that the US had been the main promoter of this Accord. The European Union (EU), which was heavily involved in the negotiations of Basel III and agreed to it, was subsequently 'materially non-compliant' with core parts of it. It is puzzling that the US and the EU, which are financial 'great powers' (Drezner, 2007), did not comply with the international standards that they promoted and shaped.

A burgeoning literature has examined the politics of standard-setting at the international level, whereas a limited number of scholarly works have examined the politics of state compliance. By bringing together these two bodies of literature in a systematic way, this paper develops an innovative explanation that highlights the 'disjuncture' between the international standard-setting process and the domestic process of compliance. Two causal mechanisms that connect the international and domestic levels are identified and explained. In the first stage, at the international level, elected officials de facto delegate international standard-setting to domestic regulators, who gather in international fora and negotiate with their foreign counterparts. Large, internationally-active interest groups extensively mobilize and, to a large extent successfully, articulate their preferences, unlike domestic interest groups. In the second stage, at the domestic level, compliance problems arise because international soft law often does not reflect the preferences of important domestic constituencies, which form alliances and team up with elected officials in order to resist compliance (*tout court* or in part) with international standards.

The empirical pattern explicated in the paper is important because by examining the link between standard-setting at the international level and compliance at the domestic level this research highlights the (at times difficult) interactions between unelected regulators, elected officials, and interest groups. It also draws attention to the (mainly domestic) voices that are

‘silent’ (i.e. they do not sufficiently engage in) or are ‘silenced’ (they are overlooked) in the making of international soft law, but get a ‘voice’ (sometimes, a powerful one) in domestic rule-making concerning compliance. This novel explanation, which is developed with reference to finance, can potentially be applied to other areas of soft law.

By linking the international and domestic regulatory processes together, this paper speaks to the literature on the ‘new interdependence’ (Farrell and Newman, 2016), and the notion that domestic regulatory changes are subject to ‘policy feedbacks’ (Newman and Posner, 2016) deriving from international regulatory changes. However, the explanation articulated in this paper qualifies the extent of domestic regulatory changes resulting from policy feedbacks, if influential domestic coalitions mobilise to oppose compliance with international soft law. This paper also contributes to recent calls in the field of international political economy to pay more attention to domestic-systemic interactions. The ‘open economy politics’ approach, which has been adopted by many works on trade or finance, has investigated how domestic forces shape national preferences and actions at the systemic level. This ‘methodological reductionism’ (Oatley, 2011) has examined the dynamics of domestic politics in isolation from broader international or macro processes (Blyth and Matthijs, 2016).[1]

The structure of the paper is as follows. It first reviews the literature on state compliance with international soft law, pointing out the limitations of existing explanations. It then outlines the explanatory framework of this paper. The analytical leverage of this explanation is assessed through a structured, focused comparison and process-tracing of the making of Basel II and Basel III, and the implementation of these accords in the US and the EU. This case selection is instrumental in order to examine the compliance with international standards horizontally by considering the same standard across jurisdictions, and vertically by

considering the same standard (or its successor) over time. A variety of primary sources are used: speeches, policy documents, position papers, parliamentary records, and two rounds of semi-structured elite interviews with policy-makers and private sector stakeholders in the US and the EU.

2. Alternative Explanations of State Compliance with Hard and Soft Law

There is a vast literature on state compliance with international hard and soft law. This section discusses explanations at the international systemic level and at the domestic level, arguing that existing accounts do not shed sufficient light onto the empirical puzzle of compliance with the Basel accords in the US and the EU. To begin with, some scholars have pointed out the 'power asymmetries' in the international system, whereby powerful jurisdictions, which manage to project their interests in the making of international soft law, are likely have limited 'adjustment costs' and hence fewer compliance problems (Drezner, 2007; Mosley, 2010; Simmons, 2001). This account, however, does not explain why the US and the EU did not comply with the international standards on which they had a major influence.

Other scholars have linked state compliance to the specific institutional features of the international body issuing the rules and the rule-making process. For example, the higher the 'legalization' of the standard-setter, the 'precision' of its rules (Abbott et al., 2000), and its monitoring and enforcement powers (Tallberg and Smith, 2012), the higher the expected compliance with its standards. In this respect, the Basel Accords represent a 'hard case' of non-compliance because these accords are well established (they date back to 1988); they are very precise (they are more than 100 pages long); and their implementation is formally

monitored by the issuing body, the Basel Committee on Baking Supervision (BCBS), the Financial Stability Board (FSB) and the IMF, when it engages in economic surveillance. Informally, financial firms, investors and financial media also monitor compliance.

A second body of literature has sought explanations for state compliance at the domestic level. Some institutionalist accounts have focused on the number of 'veto players' (Poletti and De Bièvre, 2014). The more the domestic veto players, the more problematic domestic compliance will be. In this respect, the US and the EU are similar: the US is a federal state and the EU is a regional jurisdiction characterized by multi-level governance. Hence, both jurisdictions have several domestic veto players and a plurality of domestic regulators. The main difference is that regulatory agencies in the US issue the domestic rules that implement international financial standards. By contrast, EU financial legislation that implements international standards is co-decided by the European Parliament (EP) and the Council of Ministers. This institutionalist explanation can contribute to explaining why the US and the EU, both of which have multiple veto-players, have been non-compliant at some points in time, but does not explain why the EU complied with Basel II, but not Basel III and why the US complied with Basel III, but not Basel II.

Other rationalist, interest-driven explanations have considered the distribution of compliance costs and benefits domestically, arguing that domestic constituencies, likely to benefit from or bear the costs of compliance, mobilize for or against state compliance (Chey, 2006; Mosely, 2010; Walter, 2008). This explanation has so far been applied only to emerging economies, which are mainly 'takers' of international financial soft law, unlike the US and the EU, which tend to be 'rule-makers'. Yet, this domestic political economy account could also be extended to leading jurisdictions, where there might be domestic forces that oppose

international standards. The question then becomes why the potential domestic 'losers' in these jurisdictions do not mobilize (or do so ineffectively) when standards are set internationally, but are more successful when the agreed rules are implemented domestically. To account for this, it is necessary to link systematically the international and domestic regulatory processes.

3. Research Design and Theoretical Framework

For the purpose of this research, we define state compliance as the process of implementing international soft law domestically through the passage of legislation or the adoption of agency rules. In order to 'code' compliance, we look at the timing and the content of domestic rules. In other words, whether domestic rules are adopted according to the implementation deadlines set by the international standards (the Basel accords) and to what extent domestic rules deviate from those standards. This task is facilitated by the fact that the BCBS assessed the compliance of individual jurisdictions with Basel III. Compliance can take three values: compliant, partly compliant, and non-compliant.

The focus of the analysis is the Basel accords that set capital requirements for internationally active banks; to be precise, Basel II (2004) and Basel III (2010). These accords have been chosen because they are the least likely cases for state non-compliance for the reasons mentioned above; namely, the institutionalisation of the standard-setting process and the precision of its rules. The US and the EU have been chosen as case studies because they are the least likely cases for non-compliance: they are financial 'great powers' and therefore international financial standards tend to reflect their preferences.

The explanation put forward in this paper borrows from Putnam's two-level game (1988) and analytically links the international and domestic levels. Borrowing from Singer (2007, 2004), we consider three sets of players – financial regulators (who are unelected civil servants in regulatory agencies), elected officials (namely, politicians in the legislature and executive), and the financial industry.

At the international level, financial regulators set international standards through negotiations in technical transgovernmental fora of like-minded officials who are largely insulated from public scrutiny (Bach and Newman, 2014; Tsingou, 2010). On the one hand, national regulators are generally not bound by specific mandates in international negotiations, unlike, for example, officials in trade policy. Moreover, there is no formal domestic ratification of international soft law, unlike for international treaties. On the other hand, regulators are mindful of the preferences of elected officials and the financial industry back home because international standards will need to be given legal effects through domestic regulation and will have to be enforced vis-à-vis the financial industry.

Elected officials mostly defer to the technical expertise of regulators and de facto delegate international standard-setting to them. The preferences of elected officials concerning financial regulation are twofold: to appease voters (who value financial stability, especially in the wake of a crisis), and to appease the financial industry (which seeks competitiveness) (Singer, 2007, 2004). Elected officials are particularly sympathetic to the preferences of banks and other economic actors (notably, firms in the real economy that are funded by banks) in their constituencies.

The financial industry mobilizes to influence financial regulation in line with its (at times different) preferences (Young, 2012), which derive from the specific business model of banks and the configuration of the national banking system (Goldbach, 2015; Howarth and Quaglia 2013). The financial interest groups that lobby on international standard-setting are primarily large, internationally-active banks (Lall, 2012; Young, 2012, 2014), rather than domestic banks, consumer groups, or non-financial companies. The opportunity structure at the international level is skewed in favour of international players, which have considerable resources at their disposal and enjoy good access to international standard-setters.

Two hypotheses can be derived concerning the international standard-setting stage and can be assessed against the empirical record.

Hypothesis 1: elected officials are marginal players in international standard-setting, which they de facto delegate to regulators.

Hypothesis 2: large, internationally-active banks, which enjoy good access to international standard-setters, are more influential than domestic interest groups in international standard-setting.

During the compliance process at the domestic level, the financial standards agreed by regulators in relatively insulated transgovernmental fora are subject to heightened public scrutiny and political contestation because the distributional implications of international standards become clear both across and within jurisdictions (Mosley, 2010; Walter, 2008). Elected officials are heavily involved – de jure in the EU, de facto in the US – in the process of state compliance with international standards. Elected officials are not always happy with what regulators have agreed internationally and are sensitive to the preferences of a variety of

domestic constituencies. Despite the 'deep pockets' and the domestic power-base of internationally-active banks, the opportunity structure at the domestic level is not skewed in their favour. Domestic banks are better able to mobilize at the domestic level than at the international level. To begin with, domestic banks have good access to elected officials, especially those in their constituencies. Moreover, domestic banks can form coalitions with non-financial interest groups (Pagliari and Young, 2014). These domestic constituencies lobby politicians in order to 'adjust' – or undermine – domestic compliance with international standards. Two hypotheses can be derived concerning the process of state compliance and can be assessed against the empirical record.

Hypothesis 3: elected officials are heavily involved in the process of state compliance, vetting what regulators have agreed internationally amongst themselves.

Hypothesis 4: domestic banks successfully mobilize and team up with elected officials and firms in the real economy in order to delay or 'adjust' compliance rules.

To sum up, two mechanisms are identified in order to explain the disjuncture between the setting of international standards and state compliance with those standards. First, elected officials are on the back foot in the 'closed-door' negotiations on international financial soft law. However, they are important players during the compliance process at the national level. Second, domestic banks are less able than internationally-active banks to contribute to international standard-setting. However, domestic banks mobilize effectively during the compliance process at the national level by lobbying national politicians and forming an alliance with other domestic groups. Hence, the causal mechanisms point toward different sets of actors that mobilize at different levels. Domestic actors are more active in the second stage, forming alliances that enable them to 'shift' the outcome of the first stage, tailoring it

more to the preferences of the domestic actors. The working of these mechanisms is process-traced in the following sections.

4. Basel II

4.1 The Making of the Basel II Accord

The Basel II negotiations gained momentum in June 1999 and the Accord was agreed in June 2004.

Elected Officials in the Back Seat

The making of Basel II was mainly driven by US regulators, in particular those in the Federal Reserve (Tarullo, 2008: 90). Beginning in 1998, the Chairman of the Federal Reserve, Alan Greenspan, and, subsequently, other high-level Fed officials, repeatedly pointed out that Basel I rules failed to capture the increasingly complex operations of the largest banks (Singer, 2007, 2004; Goldbach, 2015). Consequently, a revision of those rules was needed. There was no formal mandate by the Congress to US regulators to set new international standards. The Congress held the first hearing on this matter in February 2003, whereas the Basel II negotiations had begun in the BCBS in 1999. In November 2003, the House of Representatives Committee on Financial Services sent a 13-page open letter to the US banking regulators arguing that 'Basel II should be reviewed by Congress prior to any final agreement' (House of Representatives, 2003, p. 12). Eventually, the Accord was not subject to Congressional ratification because this was not a legal requirement. In the EU, the EP held hearings on the negotiations of Basel II as late as February 2003 (EP, 2003a). In September

2003, the EP (2003b, p. 4) adopted a resolution that endorsed the proposed Basel II rules, albeit regretting that they 'came into existence without any form of democratic mandate or control by the EP'. Thus, elected officials on both sides of the Atlantic became involved relatively late in the standard-setting process concerning Basel II.

Large, Internationally-active Banks vs Domestic Banks

The Basel accords apply to internationally-active banks, whereas domestic banks do not fall within the scope of the accords. Large banks that had complex risk management models in place mobilized in earnest to convince regulators that this should be taken into account in the revision of Basel I. This later became known as the 'internal ratings-based' (IRB) approach (Goldbach, 2015; Lall, 2012; Young, 2012). The Institute of International Finance (IIF), which represents internationally-active financial institutions, mobilized in a timely and sustained way concerning Basel II (see IIF, 1997, 2001). These banks were mostly successful in their lobbying efforts for a variety of reasons. First, the BCBS had insufficient expertise to develop the new standards on its own and had to rely on the big banks to provide technical input into the process (Tarullo, 2008). Second, large, internationally-active banks mobilized early on at the agenda-setting stage (Lall, 2012) and continued to follow closely the negotiations afterwards. Third, a Basel-centred 'policy community' of regulators and international bankers (Tsingou, 2010) gave large financial institutions good access to the regulatory process.

By contrast, domestic interest groups were less influential in the international standard-setting process. To no avail, in its response to the consultation held by the BCBS, America's Community Bankers (ACB, 2001, p. 1), a national trade association representing savings

institutions and community banks, criticized the proposed Accord for benefitting only 'the most complex and internationally active banks'. Similar points were made by the Independent Community Bankers Association (ICBA, 2003), which represents nearly 5000 community banks of small and medium sizes.

The potential competitive distortions resulting from Basel II were much less pronounced for domestic small- and medium- sized banks in Europe as compared to the US (interviews, Brussels, March and June 2007; Frankfurt, January 2006, September 2007). The European Saving Banks Group (ESBG, 2001, p. 1) recognized that parts of the Accord were 'shaped for the biggest and highly sophisticated banks'. However, like the European Association of Co-operative Banks (EACB, 2001), the ESBG supported the IRB approach because many of these banks would be able to use the 'simple' IRB model. This option was not available to small- and medium- sized banks in the US, as explained in the following section.

4.2 Compliance with Basel II in the US

During the negotiation of Basel II in late 2003, US regulators decided that the new rules would be applied only to approximately a dozen of large, internationally-active banks, which accounted for approximately about two-thirds of the assets of US banks (*The Banker*, 2 August 2002). Given the 'scale' and 'complexity' of the internationally-active US banks, these banks were required by regulators to adopt the advanced IRB approach (Ferguson, 2003). Hence, these banks would bear the costs of complying with the new complex rules, but would also benefit from the ensuing lower capital requirements. The other 7,000 or so US banks would remain subject to Basel I, and hence they would not be subject to the costs and the benefits of complying with the new rules. As the Vice Chairman of the Federal

Reserve put it (Ferguson, 2003, p. 2), US regulators sought to strike a 'balance' in the domestic implementation of Basel II, given the 'heterogeneous nature of the US banking system'.

The quantitative impact study that was conducted in the US in 2005 *after* the Accord had been agreed suggested that its implementation would result in capital reduction of approximately 15% on average and in excess of 26% in half of the large banks that would be subject to Basel II (Federal Reserve et al., 2006). Thus, compliance with Basel II would lead to a major decline of capital requirements in the US. Concerns about financial stability were voiced by the Federal Deposit Insurance Corporation (FDIC) (e.g. Bair, 2006), which is also the resolution authority, and several Congressmen (e.g. Sarbanes, Frank, Oxley). By contrast, the Federal Reserve was keen to go ahead with the domestic implementation of Basel II (e.g. Bies, 2005).

Domestic Banks Mobilize and Form a Coalition with Elected Officials

The quantitative impact study on the implementation of Basel II in the US (Federal Reserve et al., 2006) also pointed out skewed domestic distributional effects: the Accord would disadvantage US banks outside its scope of application; first and foremost, community banks. In fact, the application of the Basel II accord to internationally-active banks reduced their capital requirements and gave them a comparative advantage vis-à-vis community banks. Between 2005 and 2006, the Congress, under pressure from banks, held a series of hearings on the implementation of Basel II in the US. In their testimonies before the House of Representatives and the Senate, the representatives of the ACB (2005, 2006) and the ICBA (2005) voiced their concerns about the impact Basel II on community banks from a

‘competitive perspective’. The ICBA (2005) called for a revision of Basel I to make it more ‘risk sensitive’ – which would have meant to reduce capital requirements for banks not subject to Basel II. The associations of community banks as well as individual banks raised their concerns also in their responses to the draft notice of proposed rule-making (NPR) that was jointly issued by US banking regulators in March 2006.[2] By contrast, the Financial Service Roundtable (FSR) (2005), which represented leading banking, insurance and asset management companies, argued that the advantages of Basel II ‘substantially outweigh the drawbacks’, albeit it called for a ‘principles-based [meaning light-touch] interpretation’.

Members of Congress were particularly sympathetic to the concerns of community banks because congressional districts in the House of Representatives are geographic, hence many of these districts have small- and medium- sized banks, whereas the large banks are concentrated in New York, California, and South Carolina (Lavelle, 2013, p. 27). This contributes to explaining why the large banks, despite their lobbying power, did not manage to press their case for the implementation of Basel II more successfully. Some members of the Congress from both parties were so dissatisfied with Basel II that they proposed a bill for the establishment of an inter-agency committee to develop a uniform US position before the BCBS and to require a review the Accord (House of Representatives, 2005). Eventually, the proposed Bill was not adopted, but the fact that its proponents were from both the party in office and the one in opposition rules out an explanation based on partisan politics.

Given the resistance from the community banks, the Congress, the Office for the Comptroller of the Currency (OCC) (which is the regulator of community banks), and the FDIC (which supervises state-chartered banks and savings institutions that are not members of the Federal Reserve System), the federal banking regulators delayed the adoption of the NPR on Basel II

to September 2006. In an attempt to appease the concerns about the competitive implications of Basel II, the NPR introduced additional safeguards designed to prevent major declines of capital for large internationally-active banks. This elicited a negative response from the targeted banks. Some of the most outspoken criticisms came from Citigroup, JPMorgan, Wachovia and Washington Mutual (2006), which, in a joint response, argued that the NPR was 'inconsistent with the objectives of the Basel II' and would 'give foreign banks a competitive advantage over US banks'. Along similar lines, the FSR (2006) argued that the 'NPR is not the same as the Basel II. The NPR includes a variety of provisions that are not part of Basel II…The NPR should be harmonized with Basel II'. In December 2006, as advocated by the community banks (interviews, Washington, May 2013, see also ICBA 2005), US regulators issued a NPR concerning the revision of Basel I into Basel IA, reducing capital charges for small domestic banks not subject to Basel II against several kinds of exposures (Verdier, 2012). In their joint response, the ACB, ICBA and ABA (2006) welcomed the NPR on Basel IA.

The rules implementing Basel II were eventually adopted by US regulators in December 2007, after the deadline set by Accord had elapsed. Important provisions of Basel II were not given legal effect or were substantially modified: internationally-active US banks were required to adopt only the advanced IRB approach and remained subject to both Prompt Corrective Action and the leverage ratio. Furthermore, a temporary 'floor' based on the Basel I requirements limited the amount of capital reductions (Federal Reserve, 2007). In practice, Basel II was not implemented in the US prior to the international financial crisis that broke out in 2008.

4.3 Compliance with Basel II in the EU

The EU decided to comply with Basel II by revising the Capital Requirements Directive (CRD) II, which became the CRD III. The CRDs applied to all banks and investment firms in the EU, not only to internationally-active banks. The European Commission's legislative proposal, which was put forward in early 2005, shortly after the signing of Basel II, was eventually co-decided by the Parliament and Council in June 2006.

Unlike in the US, the application of Basel II did not trigger competiveness concerns in the EU (interviews, Brussels, March and June 2007). Thus, smaller banks did not mobilize to pressure elected officials to delay or water down compliance. A study conducted by Price Waterhouse Coopers (2002) on the instructions of the Commission suggested that the distributional effects of complying with Basel II for EU banks were much less skewed than in the US, de facto ranging from a capital reduction of 3% to a capital increase of 2%. Moreover, there would not be a major decline of bank capital that could pose a risk to financial stability – the Commission estimated all reduction of capital requirements for banks to be an average of 5% (Commission, 2005). During the intra-EU negotiations on the CRD III, two 'sticky' issues concerned the powers of the 'consolidating supervisor' for EU cross-border groups and the calibration the trading book for investment firms (for more details, see Quaglia 2014). However, these issues were not relevant to compliance with Basel II, which did not discuss group supervision and did not apply to investment firms.

5. Basel III

5.1 The Making of the Basel III Accord

The global financial crisis brought into sharp relief the inadequacy of existing capital requirements and therefore the need to revise the content of Basel II. The Basel III accord was agreed in December 2010 (BCBS, 2010).

Elected Officials in the Back-Seat

The Basel III accord was negotiated by national regulators gathered in the BCBS. Neither in the US nor in the EU there was a formal mandate from elected officials to do so. However, the Congress instructed regulators to enhance capital requirements in the Dodd-Frank Wall Street Reform and Consumer Protection Act. The relevant provisions also made a general reference to 'international policy co-ordination' on the matter. The Congress held the first hearing on Basel III in September 2010, when the Accord was close to being agreed. Similarly, the EP (2010, p. 24) issued a resolution in October 2010, urging the BCBS to 'take proper account of such specificities and of the different types of risk affecting the banking sector' and calling on the Commission 'to be more pro-active' in the Basel III negotiations 'to actively promote and safeguard European interests'.

National parliaments across Europe discussed Basel III when the agreement was about to be signed (for example, the Italian parliament held the first hearing on the matter in November 2010), or once EU implementing legislation had been put forward (for example, the French parliament discussed the proposed EU legislation in September 2012). The main exception was the German parliament, which intervened in May 2010 at a critical stage in the negotiations of the Accord, given the high political salience of banking regulation in Germany (Bundestag, 2010). The three main political parties opposed a major tightening up of capital requirements, pointing out the need to preserve 'the supply of credit – especially to

small and medium enterprises – in the German economy' (Bundestag, 2010, own translation). Since the document was jointly prepared by parties in office and in opposition, this rules out an explanation based on partisan politics.

Large, internationally-active Banks Vs continental European Banks

The financial industry was on its back foot during the negotiations of Basel III and was therefore less influential than pre-crisis. However, large, internationally-active banks, which were mostly US and UK banks, were better able than the majority of continental European banks to promote their preferences (Lall, 2012; Young, 2014). The IIF (2010) mobilized in earnest, painting a doomsday scenario of the detrimental effects that higher capital requirements could have on the real economy as well as increasing costs for banks. The IIF was also critical of the additional capital surcharge proposed by the BCBS for globally systemically important banks, arguing against 'simplistic solutions that focus on the size of firms'.

Continental European banks, especially small- and medium- sized domestic banks, were much less successful in getting their voice heard in Basel. First, Basel III was written with banks funded by equity finance in mind, placing emphasis on common equities in Core Tier 1 capital (interviews, Brussels, June 2011; Paris, May and July 2011). Yet, the external funding of many European banks, especially small- and medium- sized ones, came from other sources, often combining features of debt-equity instruments, the so-called 'hybrids' (interviews, Frankfurt, July 2011). The association of German banks, where saving and cooperative banks have a predominant influence, asked for the inclusion of 'hybrids' as acceptable capital instruments (Zentraler Kreditausschuss, ZKA, 2010a). French banks,

which combined banking and insurance activities in one entity, opposed banning the 'double counting' of capital (Fédération Bancaire Française, FBF, 2010a). Second, European banks opposed the introduction of a leverage ratio (see e.g. ZKA, 2010a; FBF, 2010a), which was particularly problematic for small- and medium- sized banks, such as German landesbanken and sparkassen, and French mutuals, which lacked equity capital. Third, continental European banks wanted a lower risk-weight for loans to small and medium enterprises (Young, 2014), which constitute the bulk of the business for small- and medium- sized banks.

The Basel III rules that were eventually adopted accommodated some of the requests of large, internationally-active banks, as suggested by the comparison between the first consultative document (BCBS, 2009) and the final accord (BCBS, 2010). By contrast, Basel III rules were less accommodating towards the issues that concerned continental European banks (Young, 2014). The hybrids and the double counting of capital were banned, the leverage ratio was introduced, no lower risk-weight was given to loans to SMEs, and liquidity rules were set. It is noteworthy that on some of these issues, such as loans to SMEs, European regulators were not amenable to the concern of banks in their jurisdictions (Keller, 2017).

5.2 Compliance with Basel III in the US

In the national implementation of the Basel III accord, US regulators had to take into account the banking provisions of the Dodd-Frank Act, in particular the Collins Amendment, which set two floors for risk-based capital requirements and leverage ratio. In June 2012, the Federal Reserve, the OCC and the FDIC proposed rules that implemented Basel III and incorporated the changes required by the Dodd-Frank Act, including the Collins Amendment. US regulators sought to avoid skewed domestic distributional effects (interviews, August

2011 and May 2013). On the one hand, large, internationally-active banks were subject to a supplementary leverage ratio, a counter-cyclical capital buffer, and higher capital requirements, following the updating of the advanced IRB approach. Moreover, systemically important financial institutions were subject to capital surcharge. On the other hand, community banks were also subject to Basel III, even though many of the new requirements, such as those mentioned above, would not apply to these banks (Gibson, 2012).

Small Domestic Banks Form a Coalition with Elected Officials

US banking regulators received more than 2,000 comments on their proposed rules, including several critical comments by community banks. The Council of the Community Bankers Associations (CCBA) (2012) and the ICBA (2012) argued that the Basel III rules were intended for large, internationally-active banks, not for local and regional community banks. They argued that that the new capital proposals would result in 'further consolidation of the industry' (CCBA, 2012, p. 2) and would 'limit lending, investment, and credit availability in communities' (ICBA, 2012, p. 2). The ICBA sent a petition signed by more than 14,000 people representing nearly 4,200 banks nationwide to US regulators, requesting that community banks be exempted from the proposed implementation of Basel III (interview, Washington, May 2013). In their struggle, community banks across the US enlisted the support of a majority of the Senate from both parties, which rules out an explanation based on partisan politics. More than fifty senators sent a letter to US regulators warning about the 'significant, unintended consequences' deriving from the application of Basel III rules to community banks (Toomey and Warner, 2012, p. 1).

Eventually, the Basel III Final Rule, which was issued by US regulators in the summer of 2013, provided some relief to community banks in three important areas: 'residential mortgage exposure', 'accumulated other comprehensive income', and 'grandfathered capital instruments'. The ICBA (2013, p. 2) endorsed this 'tiered approach' that properly recognized 'the difference between Main Street community banks and Wall Street megabanks'. At the same time, the new rules required a 'supplementary leverage ratio surcharge' on eight US global systemically important banks, despite the opposition of these banks (interview, Washington, May 2013), as suggested by a joint document by the ABA, the FSR and the SIFMA (2013) (these associations represent big financial players). By contrast, the ICBA (2013, p. 1) welcomed the new rules as 'a solution to address the too-big-to-fail problem, where the largest megabanks are backed with a government guarantee against insolvency because their immense size makes them critical to the stability of the global financial system'. The BCBS (2014) assessed the US as 'largely compliant' with Basel III.

5.3 Compliance with Basel III in the EU

As in the case of Basel II, the EU decided to apply Basel III to all banks and financial firms, regardless of their size.

Elected Officials in the Driving Seat

The EP was at the forefront in what Greenwood and Roederer-Rynning (2015) call the 'Europeanisation' of Basel III, which meant the modification of important provisions, such as lower risk-weight for loans to SME, and the inclusion of new provisions, notably the cap on banker bonuses. Five main party groups from the left to the right called for 'European

specificities' to be taken into account, arguing that the European economy and European banking sector should not be placed at a competitive disadvantage internationally (EP, 2010). The lower chamber of the French Parliament (Assemblée Nationale, 2012) expressed concerns about the implication of stricter capital rules for the financing of the 'real economy'. The German Bundestag and the Italian Parliament organized several public hearings on the matter, reaching similar conclusions.

The EP was so unhappy with the way Basel III had been handled that it subsequently issued a Resolution (EP, 2016, p. 2) calling for a 'strong involvement' of the EP in international standard-setting in finance. Moreover, the EP proposed 'an inter-institutional agreement' with the aim of formalising a 'financial dialogue' involving the EP in the run-up to major international regulatory negotiations. Finally, the EP urged the 'active involvement of national parliaments'. The thrust of this EP resolution is similar to that of the Congressional proposal issued with reference to Basel II: elected officials on both sides of the Atlantic demanded a greater say in international standard-setting given its far-reaching domestic implications.

Continental European Banks Form a Coalition with the Real Economy and Elected Officials

Kevin Young (2014) points out that continental European banks were not very successful in influencing the international standard-setting process in Basel, but some of the changes that these banks unsuccessful sought in the making of Basel III were later achieved when EU legislation was negotiated (see also Howarth and Quaglia, 2013). Banking associations and individual banks engaged directly at the EU level, first with the Commission, by responding to the Commission's consultation on the CRD IV, and then with the EP, which held several

meetings with banks. National banking associations also lobbied indirectly at the EU level through their participation in EU-level banking associations (interviews, Brussels, March 2012). Finally, national banking associations and individual banks lobbied at the national level. Both at the EU level and the national level, banks sought to form a coalition with companies outside the financial sector and with politicians.

During the policy discussions concerning the implementation of Basel III in the EU, several controversial issues previously discussed and mostly agreed in Basel were re-opened. For example, the ZKA (2010b) advocated a broader definition of capital, including hybrids. The FBF (2010b, p. 1) argued that 'banking and insurance groups' were 'an integrated successful business model' and therefore the double counting of insurance capital should be allowed. Both the ZKA and the FBF opposed a narrow definition of liquid assets and a leverage ratio. These points were echoed by the EU-level banking associations (e.g. EBF, 2010; ESBG, 2010), of which national associations were part.

Banks forged coalitions with the real economy. The European Banking Federation, which brings together national banking associations, and Business Europe (2011), which brings together many national business associations, issued a joint statement on the need to adapt Basel III to the EU context. The German Banking Association and the Association of the Chambers of Commerce and Industry argued in a joint document (2011) that higher capital requirements would restrict the flow of funding to the real economy. A similar joint document was issued by the Italian Banking Association and the Italian Industry Association. Unlike other cases of EU financial regulation, it is remarkable that several respondents to the Commission's consultation on the CRD IV were from outside the financial sector.[3] For example, the *Mouvement des Entreprises de France* (MEDEF) (2010, p. 1), pointed out that

the proposed rules ‘would have far reaching implications outside the financial sector’, ‘substantially reducing the access of enterprises to [bank] funding’. The German Association of SMEs and the European Association of SMEs (2010) issued a joint response that expressed strong concerns about the impact of the CRD IV on credit to SMEs in Europe.

Banks engaged in ‘noisy business politics’, seeking the attention of elected officials and the media (Keller, 2017). MEPs, especially the rapporteurs of the CRD IV proposal, were lobbied extensively by banks, but also benefited from some of the technical (albeit not unbiased) expertise provided. One of the rapporteurs of the CRD IV, MEP Kara, formed a consultative intergroup that brought together the European Association of SMEs, the ESBG and German and Austrian associations of saving banks (Greenwood and Roederer-Rynning, 2015). National governments gathered in the Council of Ministers were sympathetic towards the concerns raised by their domestic banks. The German Government (2010) and the French Government (2010) advocated a broader definition of what should count as capital, opposed the leverage ratio, warned against a narrow definition of liquid assets. By contrast, the British government (2010) supported a leverage ratio, liquidity rules, and the possibility of imposing higher capital requirements. German saving and cooperative banks, which were the most active in pressing for an ‘adjustment’ of Basel III, approached elected officials in the EP, the German Bundestag, the German Ministry of Finance and that for Economic affairs and the Chancellery, gaining their support on this issue (Keller, 2017).

In July 2011, the Commission proposed the CRD IV legislative package, which was adopted in 2013. The mobilization of banks and their engagement with the real economy and elected officials at the EU and national levels bore fruit: the CRD IV broadened the Basel III definition of what counted as capital for mutual and co-operative banks. It allowed some

hybrids as well as the double counting of bancassurance capital. Moreover, EU rules reduced risk weight for loans to small and medium enterprises. Howarth and Quaglia (2013) argue that the EU's attempt to accommodate the distinctive features of the national banking systems of its member states resulted in significant differences between the Basel III and the CRD IV. Indeed, the British Treasury minister remarked that 'We are not implementing the Basel agreement as anyone who will look at this text will be able to tell you' (*The Guardian*, 2 May 2012). Eventually, the BCBS (2014) found the EU 'materially non-compliant' with Basel III.

Conclusion

This paper asks why major jurisdictions comply (or not) with international soft law in finance. Particularly puzzling is the non-compliance of jurisdictions that substantially contribute to international standard-setting. The US was non-compliant with Basel II. In the international standard-setting process, internationally-active banks successfully mobilized to promote international standards that would reduce capital requirements for them. By contrast, US regional and local banks had scarce resources to deploy and limited access to regulators gathered in the BCBS. The main compliance problems were due to the distributional implications of the Basel II rules in the US, which pitted small- and medium- sized domestic banks against internationally-active banks. In the compliance process at the national level, the potential losers, namely the community banks, mobilized extensively and teamed up with elected officials from both parties in Congress. Concerns about financial stability also entered the picture, providing some legitimation to the domestic coalition of community banks and elected officials.

The EU was materially non-compliant with Basel III. In the international standard-setting process, internationally-active banks, especially from the US and the UK, mobilized in a timely manner, seeking to reduce the post crisis regulatory backlash. They were to some extent successful in doing so, unlike banks in continental Europe, especially domestic banks. The main compliance problems concerning Basel III in the EU were generated by the distributional implications of the new rules for the majority of continental European banks, especially for small- and medium- sized domestic banks. These banks joined forces with firms in the real economy and lobbied elected officials. Concerns about the potential negative implications of the new rules on lending to SMEs, which are the backbone of the European economy, provided some legitimation to this domestic coalition.

The paper highlights the disjuncture between the standard-setting process at the international level and the process of compliance at the domestic level, identifying two main causal mechanisms that affect compliance. In so doing, it sheds light on why and how regulators, elected officials, and interest groups mobilize and interact with a view to influencing the distributive effects of the new rules across jurisdictions and within jurisdictions. To what extent are these findings generalizable considering the scope and increasing use of soft law? First, the reiterated game between regulators, elected officials, and interest groups could be applied to examine compliance with other financial and non-financial standards set by international transgovernmental networks. Second, the two mechanisms underpinning the disjuncture between the international and domestic rule-making processes are likely to be at work in other jurisdictions. Future research could fruitfully engage in cross-sectoral and cross-national comparisons.

The explanation put forward in this research, which speaks directly to the literature on the new interdependence and policy feedbacks (Farrell and Newman, 2016; Newman and Posner, 2016), is also relevant to the broader literature on global governance. In this respect, three points are worth making. First, this research highlights the importance of considering at the same time domestic-systemic interactions, as well as rule-making and rule-implementation, whereas the literature has tended to focus on one of these aspects at the time. The shortcoming of doing so is to provide a skewed picture of global governance. Thus, the great financial powers are often portrayed as capable of achieving their goals at the systemic level, whereas important domestic constituencies might lose out in the international rule-making process. However, these domestic players might then be influential in the domestic process of rule-implementation. Or state compliance is explained only with reference to domestic politics, without considering policy feedbacks from the systemic level. Second and related to the previous point, the findings of this paper qualify the view that big players (in this case, internationally-oriented banks) always win, or at least, they often get most of what they want in the regulatory process. Small players (in this case, domestically-oriented banks) can be influential, if they are able to form coalitions with other economic groups and elected officials.

Third, this research contributes to the debate on the effectiveness and democratic legitimacy of global governance (Zaring, 2013; see also Verdier, 2012). Elected officials are one step removed from international standard-setting and so are domestic interest groups, which tend to engage late and rather ineffectively in the international regulatory process. The underplaying of domestic voices might facilitate the reaching of an agreement amongst regulators at the systemic level. However, it generates compliance problems when dissenting voices team-up at the domestic level, challenging the legitimacy of international soft law and

ultimately the effectiveness of global governance. Overall, this paper suggests a rather sombre assessment of the effectiveness of global governance: the two main jurisdictions worldwide have been non-compliant with the most important financial standards over the last ten years, despite the fact that they had been the main promoters and shapers of those standards.

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[1] I wish to thank a reviewer for this point.

[2] See https://www.fdic.gov/regulations/laws/federal/archive.html

[3] See https://circabc.europa.eu/faces/jsp/extension/wai/navigation/container.jsp?FormPrincipal:_idcl=FormPrincipal:libraryContentList:pager&page=3&FormPrincipal_SUBMIT=1&org.apache.myfaces.trinidad.faces.STATE=DUMMY

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