



**THE LONDON SCHOOL OF ECONOMICS
AND POLITICAL SCIENCE**

**Global Financial Governance and the Question of
Influence: Examining the role private actors play
in international financial standardisation**

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of the London School of Economics and Political Science for
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Abstract

This study addresses the question of how international financial standardisation is influenced by private actors. It firstly proposes that private influence is part of a 'supply and demand' relationship where regulators demand private power capabilities to enhance their own political or policy needs and private actors willingly supply these capabilities to influence outcomes. Captured outcomes as a result of this relationship are likely to arise when demand for a specific private capability is high; that is, when regulators are not able to fulfil their regulatory roles and policy requirements without private power capabilities, due to the specialised and technical nature of specific regulatory issue areas. However, captured outcomes are not likely to arise when demand for private capabilities is low. Demand for private power may be low when private power capabilities have fulfilled the regulator's initial policy purpose, or when regulators perceive the capability to be a threat to their political and/or policy making authority. Following on from this, the study then explores how supply and demand relationships produce outcomes that are captured or not. The study's central thesis is relationships that mutually benefit both regulators and private market actors are bound by institutions and as a result, private influence may be enhanced and/or constrained in institutionalised settings. Regulators will use institutional mechanisms to include private actors when the demand for private power is high, and exclude private actors when the demand for private power is low. This means that whilst institutions can facilitate capture, they can also frustrate and constrain private actors from producing outcomes which are favourable to their vested interests. As a result, financial standards outcomes are likely to encapsulate both public and private interests, the extent of either depending on the supply and demand dynamics interceding with institutional mechanisms.

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Abbreviations

Basel I	The first Basel Capital Accord 1988
Basel II	Basel II Capital Framework
BBA	British Bankers' Association
BCBS	Basel Committee on Banking Supervision
BIS	Bank for International Settlements
CAD	Capital Adequacy Directive
CEBS	The Committee of European Banking Supervisors
CEO	Chief Executive Officer
CP2	Basel II Second Consultative Paper
CP3	Basel II Third Consultative Paper
EBF	European Banking Federation
EC	European Commission
ECB	European Central Bank
ED	IASB Exposure Draft
EU	European Union
FASB	Financial Accounting Standards Board
FSA	Financial Services Authority
FSAP	Financial Sector Assessment Program
FVO	Fair Value Option
G-7	Group of Seven
G-10	Group of Ten
G-20	Group of Twenty
GAAP	Generally Accepted Accounting Principles
GDP	Gross Domestic Product
IAA	International Actuarial Association
IAIS	International Association of Insurance Supervisors
IAS	International Accounting Standard
IASB	International Accounting Standards Board
IASC	International Accounting Standards Committee
IASCF	International Accounting Standards Committee Foundation
IFI	International Financial Institution
IFRS	International Financial Reporting Standards
IIF	International Institute of Finance
IMF	International Monetary Fund
IOSCO	International Organisation of Securities Commissions
IRB	Internal Ratings Based approach

ISDA	International Swaps and Derivatives Association
LIBA	London Investment Banking Association
LTV	Loan-to-value
MNE	Multinational Enterprise
NAIC	National Association of Insurance Commissioners
OECD	Organisation for Economic Cooperation and Development
OTC	Over-the-counter
P&L	Profit and Loss
QIS	Quantitative Impact Study
ROSCs	Reports on the Observance of Standards and Codes
SAC	Standards Advisory Council
SEC	US Securities and Exchange Commission
SME	Small and Medium Enterprises
Solvency I	EU Solvency I Directive
Solvency II	EU Solvency II Directive
STA	Standardised Approach
UN	United Nations
US	United States
VaR	Value at Risk

1

Introduction International Financial Standardisation and the Question of Influence

The global financial system has experienced one of the most serious financial crises since the Great Depression¹. As the International Monetary Fund (IMF) Chief Economist Olivier Blanchard grimly announced in January 2009, “We now expect the global economy to come to a virtual halt” (IMF 2009). The current global economic climate is therefore timely as it lends serious weight to the urgent need for policymakers around the world to establish new ways of governing a ‘new world order’ in globalised financial market activity. It also presents an opportunity to understand and evaluate how the current architecture for global financial governance was unable to stem the systemic breakdown of financial markets.

Private influence over financial policymaking has been a particularly pervasive theme in commentary on the causes of the global financial crisis². Politicians and regulators in the advanced economies have acknowledged “major failures in the financial sector and in financial regulation and supervision” as fundamental causes of the crisis, allowing excessive risk taking and leverage to build up in the global financial system (Group of 20 2008). The former Chairman of the Federal Reserve Alan Greenspan acknowledges that he “made a mistake” in presuming that banks were

¹ The global financial crisis is with reference to the period 2007-2009.

² Refer Chapter 2 for more examples of policymakers and academics accounts of the causes of the global financial crisis.

capable of protecting the interests of their own shareholders (Greenspan 2008). Nobel Prize winning economist Joseph Stiglitz (2009) has blamed such “capitalist fools” for embracing such a fundamentally flawed economic philosophy.

Notwithstanding the global financial crisis, private influence over public policymaking has been a core issue that has interested scholars from the economic, political and social sciences for some time. The question of private influence is a pertinent one in an era of financial globalisation where ‘influence’ transcends national borders into global policymaking forums. This study also looks more fundamentally at the issue of influence and how influence is conceptualised in the field of international financial standardisation. In particular, it looks at how private actors are involved in the formation of international financial standards³ and the nature of the relationship between private actors and policymakers. It specifically addresses the question of how international financial standardisation is influenced by private actors and the impact that this influence has on standards outcomes.

This study conceptualises private influence in international financial standardisation as part of a ‘supply and demand’ relationship where regulators demand private power capabilities to enhance their own policy or political needs and private actors willingly supply these capabilities to influence outcomes. It proposes that captured outcomes as a result of this relationship are likely to arise when demand for a specific private capability is high; that is, when regulators are unable to fulfil their regulatory roles and

³ The formation of international financial standards is otherwise referred to in this study as international financial standardisation.

policy requirements without private power capabilities, due to the specialised and technical nature of specific regulatory issue areas. However, this study also proposes that captured outcomes are not likely to arise when demand for private capabilities is low. Demand for private power may be low when private power capabilities have fulfilled the regulator's initial purpose, or when regulators perceive the capability to be a threat to their political and/or policy-making authority.

Following on from this, the study then explores how supply and demand relationships produce outcomes which are captured or not. The study's central thesis is that because regulators lack formal legislative authority in transnational governance arenas, they utilise institutional mechanisms as a primary substitute for this in order to either enhance or constrain private power. At the transnational level of governance, relationships that mutually benefit both regulators and private market actors are bound by institutions and as a result, private influence may be enhanced and/or constrained in institutionalised settings. Regulators will therefore use these mechanisms, in the form of adopting institutional practices, to include private actors when the demand for private power is high, and exclude private actors when the demand for private power is low. This means that whilst institutional practices can facilitate capture, they can also frustrate and constrain private actors from producing outcomes that are favourable to their interests. As a result, standards outcomes are likely to encapsulate both public and private interests, the extent of either depending on the supply and demand dynamics interceding with the use of institutional mechanisms.

1.1 Global financial markets and the discreet world of international financial standardisation

Why international financial standardisation? Globalised financial markets and domestic regulation

International financial standardisation or ‘standardisation’ in short refers to international efforts to coordinate domestic regulatory approaches to produce what is considered ‘best practice’ for financial regulation. They are ‘soft’ laws or rules and are therefore seen as voluntary codes of practice that states officially implement on their own accord. Whilst the concept of standard-setting is not necessarily new, one remarkable characteristic of standardisation has been its widespread proliferation in the last few decades across a diverse range of issue areas. The IMF for instance lists twelve different international standard setting agencies for ten different issue areas in finance, some of which are even private industry organisations⁴.

The question that is raised is why standards and why ‘technocratic’ standard-setting agencies? Globalised financial activity and its associated risks have posed a serious dilemma for financial regulators. This is because financial conglomerates are often made up of branch networks, subsidiary networks and joint ventures, and the regulatory treatment of these various pieces of the conglomerate puzzle will depend and differ across regulatory jurisdictions. Branch networks for instance are considered to be part of the same legal entity as the parent company, and branches established in foreign jurisdictions are therefore considered to be regulated by the parent

⁴ The issue areas are: Accounting, Anti-Money Laundering/Combating the Financing of Terrorism (AML/CFT), Auditing, Banking, Corporate Governance, Data, Fiscal Transparency, Insolvency and Creditor, Monetary and Financial Transparency and Securities. Refer to the IMF website, <http://www.imf.org/external/standards/agency.htm>

company's regulatory authority. Foreign subsidiaries however are legally independent from their parent institution. This means that foreign subsidiaries come under the regulatory jurisdiction of the country in which it is incorporated and therefore the rules that apply to the parent institution may differ markedly from those rules applied to its subsidiary. In contrast to branches and subsidiaries, joint ventures sit within the 'grey zone' of regulatory jurisdiction, and depend ultimately on the domestic laws applicable to rules governing foreign ownership. Theoretically (and practically), one financial conglomerate operating globally could be regulated by numerous domestic regulatory authorities. The implications for regulatory arbitrage are clear if those authorities apply different rules to the same transactions within the same conglomerate.

The dilemma is that whilst financial transactions are taking place through complex conglomerate networks across countries, regulation is still firmly rooted in domestic legal jurisdictions. This difficulty has been described as the fundamental conflict between a globalised market and localised state control (Blair 1998: 398). International standards therefore are, by their very definition, designed for differences in national supervisory systems so that the same rules and standards for supervision can be adopted and then adapted to suit local legal structures and supervisory techniques. International standards rely on what the Basel Committee on Banking Supervision (BCBS) has described as 'consolidated supervision' which means that supervisors around the world adopt the same practices (as recommended by these international standards) when dealing with globally

active financial conglomerates⁵. International standards are thus a function of both sovereignty on the one hand and globalisation on the other.

In principle therefore, the proliferation of standards solves the difficult contradiction between the globalisation of financial markets and the sovereignty and prerogatives of domestic regulation. Standardisation allows for regulation to rest with domestic regulators whilst at the same time creating global uniformity so that global capital can be monitored throughout a global regulatory 'web'. Standardisation as 'soft law'⁶ therefore has been a much more appealing solution to the problems associated with financial globalisation and has therefore proliferated at a much faster rate than more formal law. However, unlike the well known international financial institutions such as the IMF, World Bank or even institutions such as the Organisation for Economic Cooperation and Development (OECD) or the United Nations (UN), which have attracted a lot of public attention for their mandates in international financial governance, little is known about the international standard-setting regimes in the wider public, despite their significant mandate. In fact, these technocratic bodies have little to do with broader public constituencies, other than the ones that take an active interest in their work, which are the financial sector and financial regulators.

Prior to the onset of the global financial crisis, the nature and proliferation of efforts by standard-setting regimes to govern financial globalisation through international financial standardisation had been

⁵ Refer BCBS, History of the Basel Committee and its Membership, <http://www.bis.org/bcbs/history.pdf?noframes=1>

⁶ However, the 'softness' of standards is increasingly being called into question, not only because of the pressure to follow the lead of the dominant markets but also because of the role international financial institutions have played in promulgating these standards as part of their surveillance and financial market development mandates. See for instance Simmons (2000) who argues that the dominant regulator uses various means to get others to harmonise.

increasingly scrutinised by scholars. The exclusivity of this new breed of technocratic elite was seen to be problematic because these governance forums were argued to be disproportionately influenced by the market (Baker 2006). Despite the attention that this issue has attracted from an increasing number of scholars, it still remains a vexed topic, with debate focusing not so much on whether policymakers are influenced by private market actors but rather, how they are influenced. These debates form part of a wider literature that highlights the growing concerns surrounding the role of private actors in international financial governance, which are explored further in this study.

The question of influence: state power, transnational capture and private authority in international financial standardisation

Scholarship in the field of international financial standardisation has provided a rich cross section of approaches that account for private influence. Earlier accounts of international financial standardisation encapsulate the way in which powerful states, their domestic institutions and domestic political pressures influenced the production of international financial standardisation outcomes. Private influence in this literature is embedded within the domestic political economy, and standards outcomes at the international level of coordination are argued to be the result of state power (Kapstein 1994, Oatley and Nabors 2001, Simmons 2001, Drezner 2004, Singer 2004).

More recent developments in the literature on private influence in international financial standardisation highlight the transnational characteristics of private influence, where private market actors not only participate directly in international financial policy forums but also exercise

their own ‘authority’ in financial governance (Baker 2006, Cutler et al 1999). Rather than seeing private influence as embedded within a domestic political structure, private actors from the major economic powers are identified as agents in their own right, acting on their own behalf in increasingly global networks. Private influence in this conceptualisation transcends domestic national borders and is seen to operate directly at the global standard-setting level.

This literature also characterises standard-setting regimes as a type of ‘transgovernmentalism’⁷ involving specialists in a particular regulatory area who are focused solely on technical problem solving (Baker 2006:17). Private sector participation is said to have become increasingly important in this transnational setting, where the close nature of interaction between public regulators and financial institutions has provided financial sector actors with more opportunities to influence and capture policy making in monetary and financial governance (Underhill and Zhang 2003, Baker 2006, Mosley 2006). The main problem highlighted by scholars is that there is a ‘democratic deficit’ in the composition of standards regimes. The composition of standard-setting regimes is seen to be unrepresentative, comprising not only the elite few from the advanced economies but also private market participants (Baker 2006). Furthermore, because deliberation and discussions focus on detail and are highly technical, to the wider public these discussions and policy deliberations “appear to be impenetrable and opaque” (Baker 2006:17).

⁷ Transgovernmentalism was a term used by Keohane and Nye (1974).

Policy deliberation is above all characterised as exclusive and narrow, where the standardisation process is said to lack any form of accountability as it is by its very nature a transnational regime of private interests that extend beyond any one particular state (Underhill and Zhang 2003). What is most concerning for some scholars is that whilst the operation and practices of financial sectors have a direct impact on the broader community and public interest generally, it is only “significant players in national financial sectors who tend to be listened to by the constituent regulatory authorities involved in these types of technical solving networks” (Baker 2006: 17). Consequently, it has been argued that international financial standards regimes have become instruments of private influence and private economic interests as opposed to the interests of the public (Underhill and Zhang 2003).

The implication of these claims is that this ‘new world order’ of interlinked institutionalised networks of public regulators and private market interests poses significant dilemmas for the governance of global finance (Slaughter 2004). On the one hand, finance is inherently technical and requires an in-depth knowledge of the way in which its complexities operate. However on the other hand, critics of this view argue that the governance of global finance is not simply a technical issue and more importantly has broader political and public welfare implications (Underhill 1995, Porter 2001, Griffith-Jones 2003). The discreet and specialised nature of these standard-setting regimes is therefore seen to be a problematic area of financial governance which many scholars believe is highly susceptible to industry influence and capture.

Prior to the global financial crisis, scholars had warned that this setting “provide private interests with the opportunity to capture policy-making and regulatory processes in the financial domain and to influence the nature of monetary and financial governance” (Underhill and Zhang 2003). The fact that private market actors are involved in the development of international financial standards, which by definition are supposed to govern their behaviour has increasingly been scrutinised. Above all, these scholars have argued that the involvement of private actors in standardisation is argued to produce ‘winners’ and ‘losers’ and the winners in this case are private market interests. This means that public regulators not only act on behalf of private interests, but they have also normatively ‘bought-in’ to the normative discourse which underpins the market. Regulation as a result becomes ‘market-based’ and in this environment, “greater levels of autonomy are necessarily conferred upon market actors” (Underhill 1995: 257).

This study shares the assumptions made in this transnational body of literature that private market actors have become a core feature of new forms of authority and governance in the global realm (Graz and Nolke 2007). However, where it seeks to further its inquiry is how this feature of private influence affects policy outcomes. Research on transnational governance that encompasses both public and private elements is a fertile ground for exploring private influence in international financial standardisation. Nevertheless, an underlying weakness found in the existing literature is that it pre-determines both outcome (captured outcomes) and causality of outcome (private influence) without addressing the causal mechanisms which lead to a situation of private capture.

Private actors who participate in these global deliberative spaces are assumed to affect outcomes because of their close interaction with policymakers, but there is limited analysis on how participation and closeness in these forums leads to capture. This study argues therefore that there is further scope to enrich the literature by examining what participation and closeness constitutes and how participation and closeness produces outcomes. This may then shed light on how private actors are able to influence these global forums.

1.2 Private influence in international financial standardisation: core propositions

Core propositions: participation and closeness as the supply and demand of private power

Before examining how private participation in international financial standardisation and the close relationship between private actors and regulators can lead to captured outcomes, we begin by firstly looking at what ‘influence’ is more generally. There are three main approaches to power in international relations which provide the basis for an understanding of what private influence constitutes. These are firstly the ‘instrumentalist’ perspectives, which emphasise the ability of private market actors to act cohesively in the political arena to pursue to political goals, using largely their material resources or other capabilities; secondly the ‘structural dependency’ approaches which emphasise power through the dependency within a market system that the state has on private sector activity and profitability; and finally the cultural or discursive approaches, which focus on the ideological paradigms that private market actors generate based on their private sector

activity (Levy and Egan 2000). Private actors possess these three sources of instrumental, structural and discursive power in political arenas and can as a result of these sources of power influence political activity.

Whilst this study acknowledges the potential importance of all three sources of power that private actors can possess, this study looks more closely at the instrumental forms of private power in standard-setting forums and how interaction between public and private actors in these forums can lead to captured outcomes. This requires us to look at the theoretical underpinnings of 'capture', which this study argues to be derived from the theory of economic regulation, pioneered by Stigler (1971). This literature stipulated that regulation was supplied to those private industry actors who had the most demand for obtaining favourable regulation, who would in turn provide political actors with votes and resources. As a result, Stigler argued that regulation acquired by the industry with the most demand is designed and operated primarily for its benefit (Stigler 1971). This literature therefore emphasises the instrumental nature of private power, where the supply of capabilities through votes and resources is the primary motivation for public actors to produce favourable regulatory 'goods'. From this perspective, at the heart of regulatory capture is an exchange of instrumental capabilities, derived from the material, technical and human resources that private actors can generate from their market activities.

Consistent with this approach, this study explores the potential of conceptualising private influence as private instrumental power that is part of a 'supply and demand' principle espoused by the theory of economic regulation. However, whilst this study adopts the underlying proposition that

there is a supply and demand for private power capabilities, it takes a slightly different approach to the model advanced by Stigler (1971) and argues that captured relationships can result from a demand by public actors for private favour and a corresponding supply of this favour from private actors, generating a 'win-win' situation for both parties. One of the core propositions advanced in this study is that private market actors don't exercise instrumental power over public actors but instead *supply* power to policymakers who have a willing and ready demand for it. Importantly, both public policymakers and private market actors engage in close relationships because they are ultimately rewarded by such a mutually beneficial exchange. At the heart of private influence in regulatory governance therefore is an incentive for both parties to engage in such mutually beneficial interaction, to the exclusion of other interested parties and or stakeholders.

Where this study fundamentally diverges from the theory of economic regulation advanced by Stigler (1971) is that capture is not treated as a given simply because there is a supply and demand relationship between regulators and private industry, but when demand for a specific private capability is high; that is, when regulators are unable to fulfil their regulatory roles and policy requirements without the input of private power capabilities. High demand is accentuated by the fact that financial regulation can be highly technical and policy development relies on a limited number of specialists with the required knowledge.

This study also challenges the presumption of outcome that is evident in the theory of economic regulation, which postulates that regulation acquired by the industry is designed and operated primarily for its benefit

(Stigler 1971). This study proposes instead that demand for private power capabilities can fluctuate in accordance with the needs of regulators at a particular point in time. As a result, demand for private power capabilities is high when regulators are dependent upon the private power source, but this demand may also fall when the capability has fulfilled the regulator's initial purpose, and/or when regulators perceive private power to be a threat to their authority. Regulators may therefore assess that the cost of acquiring private capabilities outweighs the benefit that it could potentially provide in the initial transaction costs associated with implementing policy and legislation. The self-interest of regulators to preserve their control over policy-making (thereby justifying their positions of authority) in this instance may be greater than the uncertainty of not being able to produce the required regulations.

The causal variables for captured outcomes: institutional mechanisms

Whilst this supply and demand proposition provides the reasons why captured relationships may or may not arise between public and private actors, this still does not explain *how* outcomes become captured or not. This study proposes that the way in which outcomes become captured is contingent upon institutional variables. Specifically, there are three institutionalised characteristics of international financial standard-setting that act as the causal mechanisms that can either lead to captured outcomes, or that prevent outcomes from becoming captured. These characteristics are that international standardisation is an exercise in the creation of norms, which are dependent on policy-making processes, and which are further dependent on collective decision-making structures, consisting of decision

structures internal to the institution, as well as decision-structures that sit in other vertical and horizontal governance networks.

It proposes that whilst institutional boundaries structure and bind agents, regulatory agents will attempt to strategically use institutional mechanisms to promote their interests by adopting specific practices around norm creation, policy processes and decision structures. For instance, when their demand for private capabilities is high, regulators will attempt to use institutionally generated norms, processes and decision structures to enhance private industry preferences if these preferences promote the authority of regulators. Alternatively, when their demand is low, regulators will try to use institutionally generated norms, processes and decision structures to constrain private preferences in order to generate outcomes that promote the vested interests of regulators to thereby enhance their authority.

This is because these institutional mechanisms are used as the primary 'substitute' for the legislative authority that regulators lack in the transnational governance arenas. As a result, regulatory control over institutionally generated norms, processes and decision making allows regulators to exercise some degree of authority over the outcomes that supply and demand relationships produce. This means that regulators can facilitate private preferences over norms, process and decision structure where each of these elements is crucially linked in their causality: that is, private power must 'get through' these stages in order for an outcome to be captured. Alternatively, when demand for private capabilities falls, regulators will use these mechanisms so that private preferences are not reflected in standards.

These propositions can be illustrated in Figure 1.1 and Table 1.2 where varying regulatory demand will give rise to different institutional strategies which act to either facilitate or constrain private preferential norms.

Figure 1.1 Matrix of Influence

		High Demand			
Low Threat	High demand/low threat Capture	High demand/high threat Institutional Constraints			
	Low demand/low threat Status quo	Low demand/high threat Institutional control			
		Low Demand		High Threat	

As seen in Figure 1.1, there are four main scenarios of influence based on the varying level of demand and level of perceived threat to regulatory authority. Specifically, where there is a high demand and where the use of private capabilities is perceived by regulators to enhance their authority (or a 'low threat' from private actors), institutional practices will be used to facilitate captured outcomes. The second scenario proposes that a low demand and a low threat would simply maintain the status quo. The third scenario on the other hand contemplates a high demand but correspondingly high threat from private actors. A high threat means that regulators will

perceive private capabilities to undermine their political and or policy making authority. When this occurs, it is proposed that regulators will impose institutional constraints in order to prevent private normative preferences from influencing standards outcomes. The last scenario is one where there is a low demand but a high threat from private actors, leading to regulatory control, where the objective is not only to constrain private normative preferences from influencing standards outcomes but also to control private market behaviour. This leads us to the question of what exactly these corresponding institutional practices are which regulators may resort to in order to produce these varying outcomes.

The following table 1.2 provides an illustration of the institutional practices that are adopted by regulators in order to facilitate capture, or to constrain capture, or more fundamentally control the extent of capture over outcomes. These practices are based on the three institutional characteristics of international standard-setting forums, namely institutionally generated norms, processes and decision structures. It is proposed that these practices are used instrumentally by regulators in order to enhance their interests and importantly, their political and or policy making authority.

Table 1.2 Institutional practices to facilitate or constrain private capture

	High demand/low threat ↓ Capture ↓	High demand/high threat ↓ Institutional Constraints ↓	Low demand/high threat ↓ Institutional Control ↓
Strategy ↓			
Norms	Norms sourced from private actors, drafted by private actors	Norms sourced from private actors, drafted by regulators	Norms sourced from and drafted by regulators
	Private norms introduced and adopted	Private norms reconstructed to include vested regulatory interests	Private norms rejected or existing private norms deleted
	Norms developed to allow private self-regulation	Norms developed to give regulators supervisory power	Norms developed to give regulators legislative power
Process	Deliberation with private actors undertaken throughout policy development	Limited deliberation with private actors undertaken in later stages of policy development	Deliberation with private actors not undertaken
	Frequency of meetings with regulators increased	Frequency of meetings with regulators reduced	Access to meetings with regulators denied or other stakeholders included
	Comments from private industry adopted and standards changed	Comments from private industry partially adopted and standards partially amended	Comments from private industry not adopted, no changes to standards
Decision Structure	Private decision making authority	Private decision making authority changed to regulatory decision making authority	No private decision making authority
	Decision making authority at Board, sub-committee and sub-group levels	Decision making authority at Board and sub-committee decision levels	Decision making authority at Board level only
	Private participation in committee structure	Private participation in committee structure limited or structured	No private participation in committee structure

Based on these propositions, captured outcomes in international financial standardisation are likely to arise when private actors are able to shape the underlying normative framework of standards, these standards reflecting market norms are maintained throughout the policy process of deliberation and regulatory decision-makers form consensus agreement based on these market norms. On the other hand, captured outcomes are not likely to arise if private influence over norms, processes and decision structures can not be established. This means that regulators have constrained the influence of private actors by adopting these institutional practices. For instance, when private power capabilities are seen to be detrimental, regulators can resort to using the 'policy machine' to reconstruct or fundamentally pare back the market-based discourse. They can do this by introducing new norms that counter market-based ones, or make various amendments through the policy process, thereby changing the intended utility of market norms designed to enhance private industry activities. Regulators in decision-making capacities may also choose to delay, change or even eliminate certain market-based norms at the various stages and levels of decision-making. Regulators may also resort to changing the nature of interaction or even frequency of deliberation with private actors. This means that the participation of and interaction with industry could also be closed off or opened only at the very last stages of deliberation and undertaken simply as a formality.

By establishing whether the institutional practices support or constrain capture, we may be better positioned to understand how the *nature* of private capture may differ in accordance with the varying regulatory

demand, how the power capabilities are supplied, and how these institutional practices are used to either enhance or curb private power. Above all, the propositions highlight that the relationship between public and private actors is a constitutive one; that is, neither public nor private actors can undertake governance without the other and their actions are reinforced and constituted by the actions of the other. Private capture may simply be a case of private power prevailing over outcomes. However, the more interesting possibility is that 'capture' is a much more embedded and integrative governance relationship between public and private actors. Important for this analysis is the way in which the institutional boundaries of interaction may determine the interaction between public and private actors, which can then yield important insights into how institutions can frame a balance between the exercise of both public and private power.

1.3 Research Design and Methodology

Research design, case selection and limitations

The core question that this study seeks to address is how private influence leads to captured outcomes in the field of international financial standard-setting. The corollary question is whether private capture is evident in a number of different international financial standard-setting arenas. In order to examine these questions, this study conducts a comparative empirical study of private influence in international financial standardisation. This requires us to firstly address the issue of case selection and to outline how the study intends to carry out a comparative empirical analysis.

One research design issue evident in a comparative study of international financial standardisation is that standard-setting does not occur within defined institutional parameters and the composition of standards organisations vary (from wholly 'public' to wholly 'private' or even combined). Standard-setting organisations are therefore not institutionally comparable given the differences in member composition, membership size and private industry participation. In fact, the literature surveyed earlier in this chapter conceptualises capture occurring between regulators and private actors, despite variations in the way in which private actors participate in these forums. The varying participation of private actors and the resulting closeness is treated as a constant.

For this reason, this study applies the 'most different systems design' approach to this study's comparative analysis. By adopting this design method, this study seeks to examine and explain the phenomenon of 'capture' below the system level by treating institutional variations as a constant (Anckar 2007, Meckstroth 1975). Specifically, the study intends to use cases with different systems of public-private interaction as a means to test the robustness of the study's dependent variables, which are firstly whether the supply and demand dynamic between regulators and private actors is evident across different empirical cases and secondly, whether the same institutional practices are used by regulators, despite the differences that exist across standard-setting arenas.

Based on this design method, this study has selected three case studies, which are characterised by their varying membership composition, their different financial industry focus and as a result, the different systems of

public-private interaction in place between regulators and private industry. The first case study looks at the Basel Committee on Banking Supervision (BCBS). The BCBS is the standard-setting organisation for international banking and is wholly 'public' in composition. This means that all decision-makers that make up the BCBS are public regulators either from a prudential supervisory authority or from a central bank. The interaction between the BCBS and private industry is characterised as 'external', where private industry participation is largely through formal consultative mechanisms.

The second case examined is the International Association of Insurance Supervisors (IAIS). Still considered a publicly mandated standard-setter for the international insurance industries, the IAIS is more of a 'hybrid' institution whose members consist of both public regulators and private actors from the world's insurance firms and industry associations. Unlike the BCBS, interaction between the IAIS and private industry is characterised as 'internal' where both public and private actors are present at the policy-making level.

The third case study looks at the International Accounting Standards Board (IASB). The IASB is the international accounting standards setting body and unlike the BCBS and IAIS is a wholly 'private' organisation, made up of actors from the private sector – most notably from the accounting profession but also further a field from general manufacturing to finance. This case study therefore requires a broader examination of the interaction between the IASB as the 'private' actor and public agencies as 'regulators' across governance constellations.

At the same time however, we also need to draw some parameters around the selection of these case studies so that we are testing the study's dependent variables within some comparable controls. As such, this study has also designed its research around some control variables. These are firstly their similar functionality, which is to set international standards for best practice. Secondly, they are all undertaken at the same 'level of governance', which is the international or 'transnational' level of governance. Thirdly, this study also focuses on international standards that affect prudential regulation. This allows the study to isolate the actors involved in each case, namely prudential regulators and private industry affected by the standards. Finally, it then isolates a similar prudential issue area in each case study, which are the issues involving the regulatory capital (in the case of banks), the requirement for regulatory provisions (in the case of insurers) and the meaning of equity (in the case of accounting standards), which will in general be referred to as issues relating to 'capital'. The similarity of issue area enables relative uniformity in terms of private 'interests' and hence a better comparative assessment across the three cases.

In the case of the BCBS, the two main actors identified were regulatory authorities and the large international banks (and their banking associations), predominantly from the European Union (EU) and the United States (US). In the case of the IAIS, the organisation itself makes this distinction between Members who are insurance regulators and private Observers, who are insurance firms from predominantly the EU, US and Asia, and or industry associations. For the IASB, the Board and its internal working groups were identified as 'private actors' with its public constituency

identified as government agencies, central banks or prudential regulatory authorities.

A study addressing the question of influence is not without its analytical or methodological challenges. The framework proposed in this study goes some way in providing a method for uncovering how influence operates, but there are still significant challenges that a study of this size is unable to overcome. These challenges include generating enough research and data to establish comprehensive conclusions about when outcomes are captured or constrained. It therefore seeks to limit the comparative analysis to one comparable standards outcome issue area, which is used to illustrate and support rather than prove the dependent variables in this study.

Method of research and analysis

With the broader research design in mind, this study conducted qualitative research in order to uncover a supply and demand of private capabilities and to assess whether and how institutional practices were used to support or constrain capture. The study undertook primarily field research, conducting interviews with officials from each of the three standard-setting cases. In total, the study interviewed 24 officials, 3 of which were conducted on an 'informal' basis where the officials did not wish for the author to record the interview proceedings. Specifically, six officials were interviewed for the BCBS, one of which was 'informal'. Three of these officials were from the BCBS, and the other three were external to the BCBS. For the IAIS, 16 officials were interviewed, two of which were 'informal'. All of these officials were involved with the IAIS as either Members or Observers. Four officials were interviewed for the IASB. Only one of these officials was from the IASB,

whilst the other three were from entities external to the IASB but which had direct dealings with the IASB.

Obtaining interviews with the BCBS and the IASB was clearly much more difficult than the IAIS. As a result, the author relied more on primary documents in the cases of the BCBS and IASB and used information from interviews to verify the information and analysis of these documents. On the other hand, the author was able to obtain a cross-section of information from interviewees in the case of the IAIS. As a result, the author used the information from interviews as the basis from which to examine primary materials to support and substantiate what was said during the interviews.

Interviews that were conducted on formal basis were undertaken in the offices of those participants interviewed. Each participant was offered a confidentiality agreement; the interviews were recorded and then transcribed by the author after the interview had taken place. Furthermore, for comparability, all interviewed officials were all asked the same set of questions, tailored only to when specific examples of standards given during conversation (refer Appendix 1 for the list of interview questions).

In addition to the rich first-hand accounts from officials interviewed, the study also used primary documents published by the standard-setting organisations in each case in order to verify these accounts as well as ascertain the historical timelines for the empirical examples given during the interviews. The author was also able to obtain confidential primary documents that were not available for public viewing. This allowed the author to uncover some of the dynamics which were evident 'behind closed doors' that helped the policy analysis undertaken in this study (discussed below).

There are evident limitations with the primary materials used in this study. Firstly, interviews with officials and analyses of documentation were undertaken prior to the onset of the global financial crisis, which was namely between 2005 and the beginning of 2007. As a result, the views of officials would be markedly different in the current financial climate. Secondly, access to primary confidential documents and interviews with key officials within each standards regime was made possible because the author is an employee of a regulatory authority that is a member of both the BCBS⁸ and IAIS. There are advantages and disadvantages with this privilege.

Beginning with the advantages, the author was able to access confidential documents, 'closed' meetings to which regulators only had access, and one-on-one interviews with regulators who were more open with information about the standards issues due to a professional affiliation than may otherwise be the case if the author was from the private and or other professional sectors. The disadvantages however were that national affiliations and confidentiality issues may still have been a consideration for regulators disclosing information in interviews, and hence subjective national biases are evident in the material obtained. For this reason, the author has attempted to obtain interviews from a cross-section of regulators from different jurisdictions in order to balance as well as cross-reference these different accounts.

Consideration is also given to the possibility that the author may also be constrained by professional bias. Factors that help to ensure the author's

⁸ However, it should be noted that the authority was not a member of the BCBS during the period in which research of the BCBS was undertaken, which was namely from the period 2006-2008. The authority only subsequently became a member of the BCBS in 2009 as a result of the global financial crisis. Refer to the BCBS press release found at <http://www.bis.org/press/p090313.htm>

objectivity are that the author was on leave from the regulatory authority whilst conducting research and all of the interviewees understood that the author was conducting research for the sole purpose of undertaking a doctorate. The regulatory authority has also had no part in the sponsorship of the study⁹, or had any input into the research and findings¹⁰. Furthermore, prior to the research conducted on the study, the author had no previous participation or role in the international standard-setting activities of the regulatory authority. The author therefore had limited knowledge about the activities of the standard-setting forums, which enabled the author to approach the empirical task without the bias of experience.

Based on these sources of research, there are two main tasks of this study, which are to establish the supply and demand premise for the relationships between public and private actors in each case, and then to examine how regulators have attempted to either enhance and/or constrain this relationship from producing captured outcomes. It does this by firstly establishing whether there is evidence of a power capability that is both sought by regulators and then provided by their private constituents. The way in which this is undertaken is firstly a historical analysis of the way in which each of the standard-setting organisations have developed and to establish any reasons for why there may be a historical or functionally driven demand for private sector input and a consequent 'reward' for the supply. Following

⁹ The author was given unpaid study leave to undertake the Doctorate for the period 2005-2009. The author returned to the regulatory authority from 2007-2008, and again from April 2009 to the current period.

¹⁰ The author has only used material from interviews with officials who are employed at the regulatory authority and who have played an active role in the standard-setting activities of the case studies in this study.

on from this is the need to then uncover the specific empirical circumstances surrounding why such a demand was evident in the case studies.

The second task is to then establish whether and how institutional practices have been used to enhance and or constrain outcomes. This involves a policy analysis of a standards outcome, which is an analysis of whether and how the content of standards differs from the start to the end of standard-setting process. Institutional practices using norms, processes and decision structures will be assessed by looking at the decision hierarchy and decision rules that allow certain actors institutional positions or access to decision making processes, and how decisions are then made through such forms as 'consensus'. The study also undertakes a close examination of the policy-making processes within each of these standards organisations, which is to assess how a standard has developed in to its 'finalised form' by looking at the actors who are responsible for drafting the standards, from where the content has been sourced, whose ideas have been incorporated during deliberation, and why particular standards come into existence over others.

This requires an analysis of a standard-setting and consultation processes for a particular issue area in each industry. As already outlined, the study will pay close attention to a similar issue area in each case study, which are the issues involving the provision of regulatory capital (in the case of banks), the requirement for regulatory provisions (in the case of insurers) and the meaning of equity (in the case of accounting standards), which will in general be referred to as issues relating to 'capital'. This task requires analysing changes to primary documents, but also requires information sourced from interviews with key officials, focusing on why particular issues

were selected in the first place, how the drafting and consultation phases impacted the content and the actors who were responsible for making or amending changes to the standards that were then reflected in their finalised form. Substantive changes in the content of standards will then be traced back to the factors that have affected those changes.

Methodological qualifications aside, the scope of this study is evidently limited to the assessment of one specific standard-setting outcome within each standards arena. Having said this, it is not the intention of the study to make broad generalisations based on the data found but rather this study intends to use the findings in each case as part of a comparative assessment as to how influence can operate across different standards-setting regimes. These findings may then help to generate further questions and scholarship on private influence in global financial governance more generally, with the intention in particular of enriching the existing literature on transnational governance, institutional accountability and institutional design.

1.4 Findings of the Study

One of the core propositions advanced in this study is that the underlying condition that fosters private influence in policymaking arenas rests on the economic principle of 'supply and demand'. Supply and demand is based upon the premise that there is a demand for a specific power capability that public regulators are in need of and correspondingly, private actors are in the position of strategically targeting and providing. Furthermore, when demand for these capabilities is high, or when regulators are unable to fulfil their standard-setting roles without specific private power capabilities and the perceived threat to their authority is low, this condition is argued to give rise

to captured outcomes. When this occurs, institutional mechanisms are likely to be used to enhance the influence that private actors are able to assert over outcomes. Evidence to support the high demand and corresponding low threat proposition was found in all three cases analysed in this study, namely each standard-setting regime had a high demand for different capabilities from their private constituents and private industry has been at the forefront of providing this power. Furthermore, evidence of regulators accommodating these sources of private power through institutional means, in order to generate outcomes that were favourable to both regulatory and private interests was also established.

The core power capability demanded by regulators in the case of the BCBS was the need for information and technical resources. The BCBS was for various reasons restricted in its ability to not only source information from the private sectors globally but also 'assemble' this information for the purpose of constructing a revised capital standard, otherwise referred to as Basel II. It was therefore highly dependent on information provided by private sources, which accentuated the closeness it had with the private sector during the consultation and deliberation mechanisms. The largely EU and US international banks were also at the forefront of providing this information. Information was in fact the primary means for the major international banks to influence the Committee in the shaping of the capital standard, particularly information that promoted the internal risk models of the banks. Given the closed nature of the BCBS and hence limited direct access to decision makers, the provision of information was a powerful way of influencing the BCBS policymakers.

This supply and demand also paved the way for the US and EU international banks to use their power capability to influence standards outcomes. In the case of the BCBS, private influence over Basel II was evident, seen primarily in the BCBS's adoption of the internal models approaches advocated by the large international banks. The need for the BCBS regulators to establish an alternative to the capital approach under the original Basel Accord was the primary motivation for the BCBS regulators to fast-track the adoption and inclusion of the 'advanced' methodologies for calculating capital requirements. This was not only the result of the large banks advocating the use of the internal models but also the result of the BCBS using institutional practices to adopt these private models. They did this through sourcing these approaches directly from the industry as part of their 'fact finding' missions, by undertaking data exercises referred to as the Quantitative Impact Studies (QIS) to verify the establishment of capital incentive structures for the advanced approaches and finally amending key components of the advanced methodologies in order to recalibrate the requirements so that they would produce capital incentives for the large international banks. The result has been that the internal models approaches included within Basel II provide net capital reductions.

For the second case study undertaken of the IAIS, material resources as well as technical expertise were the main source of private influence established in this case study. Due to the circumstances surrounding the establishment of the IAIS, this organisation found that it had limited public resources to support its ongoing viability as an international organisation. Hence public regulators were essentially in need of resources, which they

partially derived through the introduction of ‘Observer’ membership fees entitling insurance companies and lobby groups to participate directly in the IAIS’s standard-setting activity. Private Observers were given the very privileged concession of direct access to decision and policymakers in standard-setting forums as well as access to information being drafted by policymakers in return for an annual monetary fee. The IAIS is therefore the clearest case where adopting institutional practices, such as direct participation and access to information portals were granted in return for contributions.

Observers were given important access to standard-setting meetings; however what is interesting in the case of the IAIS is that even though there were a vast number of private actors who could supply the resources needed, IAIS policymakers showed particular favouritism towards a select few private actors. This was most evident in the case of the development of the IAIS’ solvency framework. In this particular issue area, the IAIS relied heavily on the strategic input of one Observer – the International Actuarial Association (IAA), who, unlike other Observers, would be singularly invited to present on topics and to provide their technical input into the IAIS solvency work. Their technical input is not only evident in the final outcome but is also explicitly acknowledged in the solvency standard.

Finally, in the case of the IASB, this study found that there was also a supply and demand dynamic evident between the IASB and public regulatory agencies, based on the need for US and EU to find a way to harmonise their different accounting systems. This gave rise therefore to the high demand for an international accounting standard-setter that was based neither on the US

nor EU system of accounting and as a result, the IASB therefore provided a politically palatable and alternative source of technical expertise which both sides of the Atlantic would be willing to comply with.

Due to this demand, public actors in this case have played a pivotal role in legitimising and endorsing the IASB's standard-setting activity. There was therefore a strategically beneficial relationship between the IASB and regulatory agencies which contributed to the significant increase in the IASB's governance stature globally. The result is that the standards that the IASB produces are now used in almost 100 countries and in some parts of the world, are also legally binding through their domestic laws, the most notable being in the EU.

Regulators in all three cases were therefore active instigators of power capabilities that were needed to enhance their roles and activities. However it is at this juncture that another significant variable comes into play and that is the way in which those regulators utilised institutional practices to constrain capture. Even though regulators initially sought private power capabilities in order to fulfil their respective mandates, the negative impact that these private capabilities were perceived to have on the authority of regulators prompted regulators to curb the full extent of private influence over outcomes, using primarily institutional practices.

This study proposes that adopting institutional practices through norm creation, policy development and decision making are the primary substitutes for the legislative instruments for enforcement that regulators lack in the global arena. What was found in each case study was not only a situation of 'capture' based on a high demand and low threat from industry,

but also a subsequent a high threat from industry, such that outcomes were in the end not wholly captured by private interests. Private influence therefore became subject to the policy ‘machine’ within the standard-setting institutions, which significantly affected the way vested interests were diluted or even reconstructed in standards outcomes that were produced. As a result, what this study consequently established was that the institutional infrastructure was a pivotal reason for why outcomes did not necessarily mirror the initial supply and demand of private power.

In the case of the BCBS, a high threat from industry was established when regulators began to assess the impact that the revised methodologies would have on their respective jurisdictions. Regulators began to perceive the changes as a threat to their national regulatory prerogatives when it became clear that the benefits would flow unevenly to the largest international banks. This created internal tensions and divisions between largely the EU and US BCBS members, which then prompted members from the EU to introduce other requirements to counter the full impact of the revised methodologies and more importantly, enhance their ability to exercise their supervisory control over banks. The result of this has been the contradictory nature of Basel II, which incorporates the adoption of private internal model paradigms to promote incentive structures to reduce capital with the imposition of other capital charges (for example, the operational risk charge) as well as the addition of Pillar 2 supervisory discretion to further increase capital requirements above minimum Pillar 1 levels¹¹. As a result, Basel II has become a complex patchwork of rules which is over 347 pages long,

¹¹ Basel II contains ‘three pillars’ each referred to as ‘Pillar 1’ (minimum capital requirements), ‘Pillar 2’ (supervisory review) and ‘Pillar 3’ (market disclosure). These will be discussed further in Chapter 4.

compared to the 30 pages of requirements under the original Accord. From the point of view of the large international banks, the BCBS has cumulatively built in elements of conservatism, thereby negating any capital incentives that they hoped would have resulted from the adoption of the internal models' methodologies. If we therefore place the case of the BCBS within the matrix of influence outlined earlier, we find that 'institutional constraints' have been put in place by regulators.

In the case of the IAIS, a high threat was also established when some regulatory members became increasingly uneasy with the direct participation of private industry Observers. These regulators perceived their authority and 'domain' of rule-making to be compromised and threatened by the presence of private actors. As a result, the regulators of the IAIS imposed deliberate rules to govern the participation of private Observers. Regulators were able to decide whether to open meetings to Observers, partially open meetings so that Observers could sit in on only some agenda items, and also close meetings so that Observers could not have any access to regulatory discussions. This ultimately led to the 'included exclusion' of Observers such that their participation was structured to ensure that the ultimate decision and influence over outcomes resided with Members. Again, when we place this finding within the matrix, we can also establish a case of institutional constraints in the case of the IAIS.

Finally in the case of the IASB, the IASB posed a high threat to regulatory agencies when it was the impact that the full application of the fair value option in IAS 39 would have on other international financial standards that threatened the authority of regulatory agencies. This is because IAS 39

impinged on the interests of banking regulators who had their own vested interest in maintaining their domination over certain paradigms, namely over the definition of capital. Consequently, the IASB has not been able to shift as easily towards a fair value paradigm because of the actions taken by regulators. Led by the BCBS, as well as other financial agencies, these agencies have imposed their own institutionalised constraints, through the imposition of carve outs and prudential filters so that the IAS 39 could not be recognised in full for prudential reporting purposes. As a result, these constraints were pivotal in the IASB's decision to substantially modify the fair value option so that it could fulfil prudential purposes. This means that prudentially regulated financial entities must report regulatory amounts that are potentially much higher than would be required under IAS 39. The case of the IASB shows some elements of institutional control applied by regulators in the EU, but by and large we can also see practices applying institutional constraints in order to limit the choice sets available to the IASB.

A comparative assessment of these findings therefore reveals a much more constrained picture of private influence and capture. The findings emphasise the importance of the supply and demand relationship between regulators and private actors, but highlight that this relationship is based on a precarious demand that is conditionally based on whether the supply of private capabilities enhances the authority of regulators. When private power capabilities do fulfil the regulator's required policy mandates, regulators will accommodate private influence by adopting institutional practices that serve to include private interests so that standards reflect these market-based norms. When they do not and are instead perceived to undermine their

authority, regulators resort to empowering their positions using quasi-legislative mechanisms through the use of institutional constraints in the international policy making domain. The case studies therefore show that based on the matrix outlined earlier, there is both 'capture' and 'institutional constraint'. Consequently, norm creation, policy reconstruction, decision rules determining deliberation and participation are found to be utilised in order to assert authority over private actors in the transnational governance arena.

These findings above all show us that private influence is part of a much larger policy and governance machinery, where both private and public actors play a pivotal role in providing inputs into the broader policy framework. Furthermore, the findings help to illustrate that balance in governance is an institutionally enmeshed 'fabric' that encapsulates both the vertical and horizontal interweaving of decision making, policy formation, deliberation and ultimately norm creation by both public and private actors within international governance. These findings therefore may help to shape further scholarship on how best to incorporate private actors in global governance and how institutions may be designed to ensure appropriate accountability to broader public welfare goals.

1.5 Outline of the Study

This study continues in Chapter 2 with a background on the current global financial crisis and the corresponding debates this has prompted from leading academic commentators about the role private influence has played in not only generating the crisis but also how global finance influences international financial standard-setting more generally. The chapter however

highlights key areas where the scholarship could be further enriched with an analysis of how private influence operates in international financial standard-setting and how it impacts outcomes. Chapter 3 addresses these limitations by providing an alternative theoretical framework for which to analyse influence in international financial governance. It further outlines the conditions and propositions to be tested in an empirical study. The empirical studies of private influence are undertaken in Chapters 4, 5 and 6. The findings of these studies then enable the study to undertake a comparative assessment in Chapter 7, which outlines the conclusions and implications of the study for the issue of global financial governance more generally.

2

Global Financial Crisis, International Financial Standardisation and the role of Private Influence

The global financial crisis has magnified the issue of private influence in global financial governance and has raised important questions about the role private market actors play in producing global regulations. It also highlights the role private influence has played in producing the regulatory environment that is being blamed for contributing to the crisis. Scholarship accounts for private influence in international financial standard-setting in a number of different ways, from the ‘two-level game’¹² approaches, to ‘transgovernmental’ capture to private authority. These approaches are examined in this chapter, in order to establish the core assumptions made about private influence in international financial standardisation. In particular, it focuses on a growing body of literature that highlights the transnational characteristics of private influence, where private market actors not only participate directly in international financial policy forums but also exercise their own ‘authority’ in financial governance (Baker 2006, Cutler et al 1999).

This study shares the assumptions made in this transnational body of literature that private market actors have become a core feature of new forms of authority and governance in the global realm (Graz and Nolke 2007). However, where it seeks to further its inquiry is how this feature of private

¹² This term was used by Putnam (1988) and is discussed in later in the chapter.

influence affects policy outcomes and whether these new forms of transnational governance support and enhance the influence and authority of private actors. Three key variables of this literature are examined, which are the actors involved, where this interaction is taking place and how, as a result, private influence materialises through participatory and deliberative 'spaces'. It can be argued that these transnational features generate outcomes which are prone to capture or that are captured, because of the direct participation of private actors in these global forums (Baker 2006, Underhill and Zhang 2005).

However, an underlying weakness found in the literature is that it pre-determines both outcome (captured outcomes) and causality of outcome (private influence) without addressing the causal mechanisms which lead to a situation of private capture. Private actors who participate in these global deliberative spaces are assumed to affect outcomes because of their close interaction with policymakers, but there is limited analysis on how participation and closeness in these forums leads to capture. This study argues therefore that there is further scope to enrich the literature by examining *how* private actors are able to influence in these global forums, and by querying whether institutional features of these new forms of global governance are causal variables for the way in which private market actors are able to influence policy outcomes.

2.1 Global financial crisis, international financial regulation, and regulatory capture

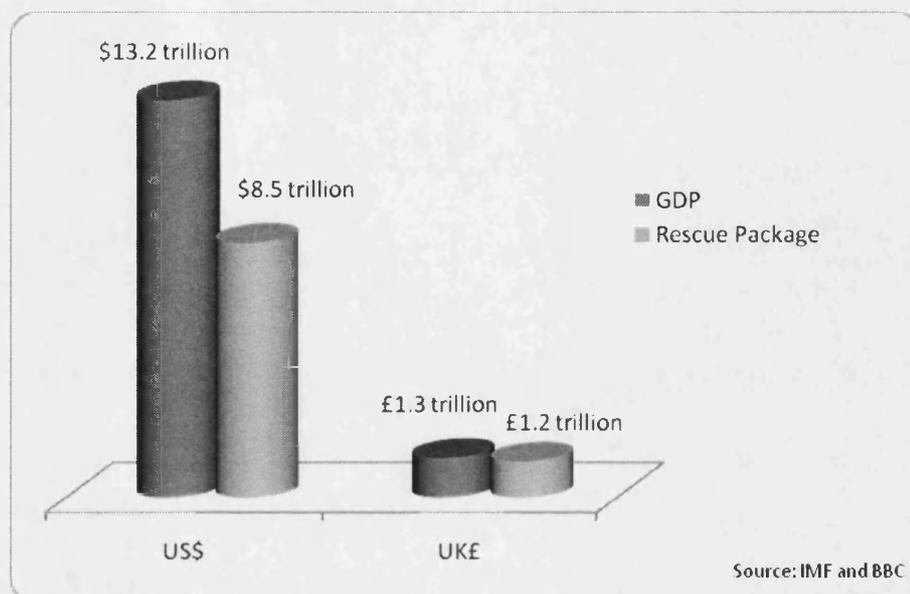
The Global financial crisis: market failure or 'capitalist fools'¹³?

As the global financial community takes stock of the events that have unfolded since what began as a sub-prime mortgage crisis in the United States (US) in 2007, questions are now being asked as to how and why this US housing crisis could have led to the systemic meltdown of global financial markets and the collapse and bailout of several global financial institutions. The magnitude of the current crisis is unprecedented in recent history, with global names such as Lehman Brothers no longer in existence, whilst others such as American Insurance Group (AIG), Citi, Bank of America, Lloyds TSB, Merrill Lynch and Royal Bank of Scotland merged with other banks and or extended government lifelines in the form of multi-billion dollar bailouts. Figure 2.1 illustrates the scale of the US and United Kingdom (UK) rescue packages in their attempt to keep the global financial system afloat¹⁴.

¹³ Stiglitz (2009)

¹⁴ Data is sourced from the IMF, World Economic Outlook Database, October 2009 found at <http://www.imf.org/external/pubs/ft/weo/2009/02/weodata/index.aspx> and the BBC at http://news.bbc.co.uk/2/hi/in_depth/business/2007/creditchunch/default.stm

Figure 2.1 US and UK rescue packages



The magnitude of the crisis is reflective of the way in which global financial markets have grown in scale and complexity as a result of financial globalisation. Financial globalisation can be understood as the result of a series of events which took place after 1971 with the end of the Bretton Woods system. The end of Bretton Woods marked a new era of a floating rate exchange system among currencies and the gradual liberalisation of financial markets and the easing of international capital controls. One of the implications of the floating rate exchange system and the liberalisation of international capital flows has been the ability and inclination of some market players to pursue more speculative short term ‘arbitrage’ opportunities in the money markets (such as the differences among foreign currencies or interest rates).

To add to such opportunities for arbitrage, the end of the fixed rate exchange system was also accompanied by the simultaneous rise of new computerised technologies that not only accelerated the pace of financial transactions made on organised stock exchanges but also paved the way towards the creation of a vast ‘over-the-counter’ (OTC) market for financial transactions. Computerised OTC markets have allowed individual market participants to enter into exchange-type transactions between themselves without having to trade as members of an organised exchange. Such computerised networks are said to have created “shadow stock markets and traders” which has further fuelled the pace of financial integration across borders (Francis 1993: 192).

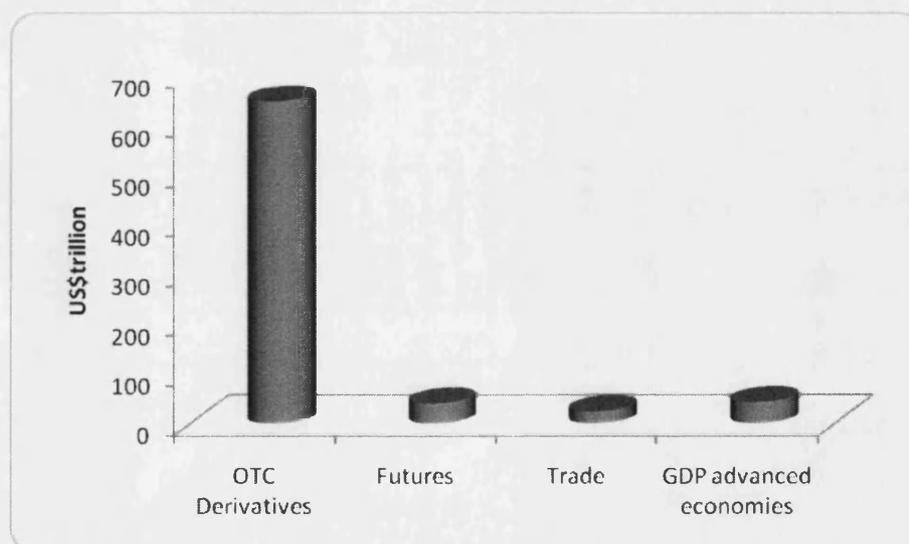
The scale of globalised financial markets and the importance of these markets to the overall global economy can not be underestimated (refer Figure 2.2¹⁵). This can be illustrated for instance by the notional amounts of both OTC and exchange-traded derivative contracts that are transacted globally. For example, the total amount of OTC contracts since 1998 has increased almost ten-fold, with the notional value of these derivative contracts worth approximately US\$684 trillion in June 2008 (from US\$72 trillion in June 1998)¹⁶. Derivative financial instruments traded on organised exchanges have also increased to significant proportions since 1998. Traded futures contracts have almost tripled to approximately US\$20 trillion in

¹⁵ Data derived from Bank for International Settlements (BIS), Derivative Statistics, statistical table 19, <http://www.bis.org/statistics/derstats.htm>

¹⁶ Theoretically the notional amount is the amount that counterparties would need to ‘settle’ when the contract ends, however this sum in practice is often offset or ‘netted’ out against matching contracts in the market. Hence, counterparties would only then need to replace the cash flow in any mismatches or differences in market values of contracts when the contract ends. However, financial institutions still face the notional credit ‘settlement risk’ if one of its counterparties fail. Refer to the Bank for International Settlements (BIS), Derivative Statistics, statistical table 19 for more details, <http://www.bis.org/statistics/derstats.htm>

December 2008, whilst traded options have increased six-fold since 1998 to around \$40 trillion in December 2008¹⁷. To place these figures into some context within the ‘real’ economy, the total value of world exports in both merchandise and commercial services in 2007 was only around US\$23.9 trillion in comparison¹⁸. Furthermore, the total aggregated gross domestic product (GDP) of all OECD countries in 2007 was approximately US\$39 trillion at current prices and exchange rates¹⁹. It is evident therefore that the scale of derivative activity dwarfs the productive sectors, or the ‘real’ economy.

Figure 2.2 Global OTC Derivative activities



The scale of global financial markets therefore is unquestionable. However, what has also been a distinguishing feature of this new financial landscape has been the increasing and ongoing consolidation of financial institutions in

¹⁷ Ibid, see table 23A for more details, <http://www.bis.org/statistics/extderiv.htm>

¹⁸ World Trade Organization (WTO), International Trade Statistics 2008, see table II.1 and table III.1, http://www.wto.org/english/res_e/statis_e/its2008_e/its08_toc_e.htm

¹⁹ Organisation for Economic Cooperation and Development (OECD), Comparison of Gross Domestic Product (GDP) for OECD member countries, <http://stats.oecd.org/WBOS/index.aspx>

the last decade. In fact, international financial conglomerates and their subsidiary networks have been a key factor in the globalisation of finance by standardising the types of financial transactions that are made available to customers across jurisdictions. A study commissioned by the Group of Ten (G-10) found that as large multinational enterprises (MNEs) increased the geographic scope of their operations, in doing so they simultaneously created a demand for financial intermediaries to provide the necessary financial products to operate in those markets, such as foreign exchange and interest rate hedging (G-10 2001).

Financial institutions in response opted to consolidate through mergers and acquisitions in order to attain critical mass in wholesale financial markets, provide the volume of business that such MNEs required, as well as maximise profit margins where higher volumes in wholesale markets are necessary to generate higher returns (G-10 2001). Banks in particular have pursued the option to merge with and acquire existing institutions within certain target markets as “the acquirer gains a more rapid foothold than would be possible with an organic growth strategy” (G-10 2001: 74). A desired outcome for banks is indeed to build “a global retail system” that is more traditionally associated within domestic contexts (G-10 2001).

To further complicate the financial landscape, financial institutions such as banks are not only merging with and acquiring other banks in order to gain critical market mass, they have also been engaged in ‘cross-sector’ acquisitions. In fact, as Herring (2003) illustrates, many well known large international financial institutions are to some extent a financial conglomerate where they have combined at least two of the three formerly

distinct functions of banking, securities or insurance. Financial groups ING and Fortis in the Netherlands, Credit Suisse in Switzerland, and Citi in the US are all such examples. A result of such conglomeration is that there has been an increase in concentration risk in certain areas of financial activity (Herring 2003, G-10 2001).

By way of example, the top 10 largest financial conglomerates accounted for approximately 55 per cent of OTC derivative trading in foreign exchange and interest rates in the major financial centres at December 1999 (G-10 2001). The top 10 financial conglomerates had similar market shares (if not larger) in debt and equity underwriting and various securities activities such as international equities and bond trading (G-10 2001). Whilst these indicators are by no means definitive evidence to suggest that global financial activity is concentrated within a certain number of financial conglomerates, it does lend weight to political concerns that financial globalisation is a rapidly expanding reality²⁰. It also explains how susceptible the global financial landscape was to the systemic knock on effect on a localised housing crisis on the rest of the world's financial institutions.

Whilst there are a number of different views and factors that ultimately led to the systemic collapse of global markets and global financial institutions²¹, the Group of Twenty (G-20) provides its assessment of the causes that led to the global credit market disruptions, which stemmed in essence from “a period of relatively low interest rates around the world (in both notional and real terms) associated with abundant global savings, a

²⁰ These concerns stemmed from the G-10 2001 Report.

²¹ Commentary on the global financial crisis is found at various news sources, such as the Financial Times, BBC, New York Times.

global ‘search for yield’ in financial markets, and what is now recognised to have been a general under-pricing of credit risk” (G-20 2008a: 3). More importantly for financial markets, “the growing importance of the ‘originate and distribute’ mortgage model and of structured financial products, facilitated a general increase in risk-taking”²² (G-20 2008a: 3).

However, even though the G-20 formally acknowledges that “market participants sought higher yields without an adequate appreciation of the risks and failed to exercise proper due diligence”, it is also quick to qualify this view with the admission that “Policy-makers, regulators and supervisors, in some advanced countries, did not adequately appreciate and address the risks building up in financial markets, keep pace with financial innovation, or take into account the systemic ramifications of domestic regulatory actions.” (G-20 2008b: 1). This recognition of essentially the mistakes made by some of the main G-20 members is a serious indictment of the role played by regulators in creating the conditions necessary for the high levels of leverage in the system.

The important question that arises therefore is how risks and leverage were allowed to accumulate. One underlying cause that commentators in the media and practitioners generally have highlighted is the failure of policymakers to adequately govern global finance. Some have attributed this to the problem that policymakers had bought in to the liberal market belief system, whilst others have attributed the crisis to outright regulatory capture (Gieve 2009, Johnson 2009, Buiters 2009, Kauffman 2009). However described, most commentators agree that policymakers were influenced by

²² Refer also to the Turner Review, Financial Services Authority (2009)

those in financial markets and as a result, policymakers have allowed financial transactions to become more opaque and increasingly leveraged (Financial Times 2009a).

Attention is swiftly turning away from the view that markets simply 'failed', to the argument that those governing the markets were essentially to blame. As the Financial Times reported in May 2009, the global financial crisis has not been a pure failure of markets but instead "financial institutions and markets operate within macroeconomic, regulatory and political framework created and maintained by public bodies, and it is not empirically difficult to point to the serious deficiencies of this framework that contributed to the present crisis" (Financial Times 2009c). Danielsson has also recognised that whilst banks have played their part "by creating all these complex structured products", essentially "they did this under direct regulatory oversight" and as a result "regulatory failures have been a significant contributor to the financial crisis" (2009: 53). High profile practitioners such as Henry Paulson, a high profile ex-Wall Street executive and former US Treasury Secretary has also categorically attributed the crisis to 'serious flaws' in the system, calling for global policymakers to co-ordinate internationally and fundamentally reform the regulatory architecture (Paulson 2009).

What were these fundamental deficiencies and flaws? The underlying cause of the current crisis is being blamed on the "cavalier thesis that less regulation is always better", which commentators are now realising was 'faulty' and 'false' (Financial Times 2009b). What has been made clear in commentary covering the crisis is the view that "economic policymakers

could have limited these dangers, but they did not do so. Instead, they allowed the bubble to inflate and let financial transactions become increasingly opaque and ever more leveraged” (Financial Times 2009a). The argument that policymakers allowed such activity to take place highlights one of the most important aspects to the failure of regulatory governance and that is the willingness on the part of policymakers to accommodate risk taking and yield seeking. The problem has not been lax regulation but the more fundamental adoption of the free market ethos, where market participants and regulatory policymakers were at one in their belief that “markets are self-adjusting and that the role of government should be minimal...” (Stiglitz 2009: 1)

Senior economic officials have also acknowledged this as the more fundamental problem. As Lord Turner, Chairman of the UK’s Financial Services Authority (FSA) commented, “the financial crisis has challenged the intellectual assumptions on which previous regulatory approaches were largely built, and in particular the theory of rational and self-correcting markets” (FSA 2009b). Nobel Prize winning economist Joseph Stiglitz has also blamed the ‘capitalist fools’ for embracing “this flawed economic philosophy made it inevitable that we would eventually arrive at the place we are today” (2009:1). Former US Federal Reserve Chairman Alan Greenspan, a well known advocate for self-correcting markets, has even acknowledged that “I made a mistake in presuming that the self-interest of organizations, specifically banks and others, was such that they were best capable of protecting their own shareholders and their equity in the firms (Greenspan

2008). As the Financial Times reported, “these are indictments of capitalists, not capitalism” (Financial Times 2009b).

Former deputy governor of the Bank of England Sir John Gieve has blamed this on the problem of regulatory capture and ‘groupthink’. In his words, “It is not so much that the private sector is full of clever people who pull the wool over supervisors’ eyes – although some of that goes on – but that banks and regulators are in constant discussion and negotiation and tend to develop shared views and shared misjudgements, as they did on structured credit and wholesale funding.” (2009: 1) Buiter has called this ‘cognitive capture’ and argues that such capture “need not take the form of bribery, blackmail, corruption or deliberate perversion of the regulator’s mandate” but rather “the process through which those in charge of the relevant state entity internalise and adopt, as if by osmosis, the objectives, interests, fears, hopes and perception of reality of the vested sectional interest they are meant to regulate.” (2009: 38) Kaufmann has also pointed to ‘capture’ in the systemic failures of oversight, regulation and disclosure in the financial sector. In his view, the problem that abounds in industrialised economies is that “undue influence is often legally exercised by powerful private interests, which in turn influence the nation’s regulators, policies and laws” (2009: 1).

It has been argued that this is what happened in the US, where “the American financial industry gained political power by amassing a kind of cultural capital – a belief system...the attitude took hold that what was good for Wall Street was good for the country” (Johnson 2009: 6). More concerning was that “a whole generation of policy makers has been

mesmerised by Wall Street, always and utterly convinced that whatever the banks said was true” (Johnson 2009: 6). As a result, Simon Johnson argues that for over the past 30 years, this sector has benefited from a process of ‘cultural capture’, “through which regulators, politicians and independent analysts became convinced this sector had great and stabilising technical expertise” (Financial Times 2009e).

Indeed, this cultural capture has been fuelled by intense lobbying by the finance sector in the US. As reported by the Financial Times, between 1998 and 2008, Wall Street investment banks, commercial banks, hedge funds, real estate companies and insurance conglomerates paid an estimated US\$1.7 billion in political contributions and spent a further US\$3.4 billion on lobbyists (Financial Times 2009e)²³. Furthermore, in 2007 the financial sector employed nearly 3,000 lobbyists, or five for each member of Congress, to influence policymaking (Financial Times 2009e). Furthermore, it is reported that “such purchasing of political influence is widely believed to have helped secure for Wall Street the repeal of the Glass-Steagall Act, which prohibited the merger of commercial and investment banks, and the blocking by Bill Clinton’s administration of a Commodity Futures Trading Commission initiative to regulate financial derivatives” (Financial Times 2009e).

It is therefore evident from these accounts by leading commentators and practitioners that ‘capture’ and influence have played a significant part in the unravelling of the global financial turmoil. But where has this ‘capture’ taken place? Commentators have referred to regulators and policymakers

²³ The figure comes from a report by Essential Information and The Consumer Education Foundation, two non-profit organisations

more generally, others to policymakers in the advanced economies and some pointing to regulators in the US. However due to the systematic nature of the global financial collapse, it would appear that the underlying issue is what Paulson described as “fundamental flaws in the system”. The issue that is central to this crisis therefore is whether the global regulatory architecture in place, in the form of international financial standards has helped to not only harmonise ‘pro-market’ liberal regulations but more worryingly, contributed to their development and proliferation among the advanced economies.

The failure of global standard-setters? The case of Basel II and fair value accounting

In the aftermath of the financial turmoil, attention and criticism has swiftly turned to the most influential international capital standard for banks and that is the Basel II Capital Framework (Basel II). Critics have argued that the Basel II rules exacerbated the crisis because of the underlying philosophy that capital should be closely aligned to a bank’s assessment of risk (Financial Times 2009d). Academics have argued that the Basel II models permitted banks to hold capital levels that were far lower than what was socially optimal, creating serious systemic risk in the global financial system, which contributed significantly to the global financial crisis (Alexander 2009). More seriously is the allegation that “Basel II permitted regulators to approve more market-risk sensitive capital models, which led to lower levels of regulatory capital and created an incentive for banks to increase their leverage levels in the structured and securitisation markets” (Alexander 2009: 880).

This in essence is one of the most important issues raised by critics and that is the propensity for Basel II to be procyclical. In short, this means

that risk-aligned capital is likely to fluctuate with the broader economic cycle, so when for instance the economy is in an upturn, capital levels go down and correspondingly in downturn, capital requirements are also likely to go up, creating funding pressures in the market and thereby exacerbating the negative economic conditions. To elaborate, procyclicality is associated mainly with credit risk and procyclicality issues are considered to be greatest under the internal ratings based (IRB) methodology under Basel II as these have the greatest use of risk sensitive measures (FSA 2006). The IRB treatments of performing assets are more risk sensitive because these measures rise and fall in a corresponding downturn and upturn in the economy.

For example, the downgrading of a credit risk rating or a deteriorating loan-to-value (LTV) on residential mortgages will put these credits into a higher risk weight. This is considered problematic because an increase in the credit risk charges and hence an increase in capital comes at a time when there is unwillingness in the market to raise new capital due to pricing and general funding pressures (eg liquidity). Banks also resort to more conservative behaviour in a downturn, by reducing their lending and thereby magnifying the downturn by causing more of a credit crunch. However, due to the fact that credit risk modelling is based on banks own IRB methodologies, the extent of procyclicality depends on the risk measures being used by different banks (FSA 2006).

The BCBS has acknowledged this to be a problem, and announced in 2009 measures to address the procyclicality in Basel II (BCBS 2009b). However the BCBS maintain that despite criticisms that Basel II has failed to

perform in the recent turmoil, overall the framework is robust and that Basel II enhances capital regulation, supervision, risk management and market transparency (Wellink 2008). The General Manager of the Bank for International Settlements (BIS) Jaime Caruana has also come to the defence of Basel II, arguing that there was no correlation between the adoption of the Basel II rules and the financial crisis (Financial Times 2009d).

Basel II is not the only international framework under the spotlight. Similar criticisms have been made of fair value accounting under the International Financial Reporting Standards (IFRS) developed by the International Accounting Standards Board (IASB). As the name suggests, fair value accounting is the valuation of assets based on their 'fair' or their current market values. It is assumed that quoted prices in an active market provide the 'fairest' measurement because it is directly observable to the market (otherwise referred to as 'mark to market') (Magnan 2009:2). However, where there is no active or observable market, certain assets are then valued on what market participants assess to be fair based on mathematical modelling exercises that are based on various economic, market or firm specific conditions (otherwise referred to as 'mark to model') (Magnan 2009).

Critics are highlighting that the problem with this methodology is that fair value accounting may actually deepen financial crises. This is due to the very simple reason that when credit markets 'seize up', asset prices fluctuate based on the market's short term evaluation of the financial position of firms and as a result further exacerbate volatility of financial markets, thereby triggering "quite erroneous decisions in the allocation of capital". (Boyer

2007: 782) Hence, from a financial reporting perspective, fair value accounting is said to magnify the changes in the value of financial assets and thereby increasing the volatility of returns through their profit and loss account. (Hamilton 2009) Put simply, when there is a crisis, the prices of assets tend to fall below their pre-crisis levels because as critics argue, marking to market forces firms to unload assets at fire-sale prices which then cause values to fall even further (Pozen 2009:86).

The allegation that fair value accounting has exacerbated the global financial crisis prompted the US Congress in 2008 to require the Securities and Exchange Commission (SEC) to undertake an assessment of mark-to-market accounting, and specifically the impact that such accounting had on the bank failures in 2008²⁴. Proponents of the fair value model have argued that such attention to the fair value accounting model is misguided and akin to ‘shooting the messenger’, particularly at a time where “transparency of financial information – no matter how painful the economic reality – will be a key ingredient in helping to restore economic confidence” (Institute of Chartered Accountants UK 2009). However, it is precisely the accuracy of this ‘transparency’ which is scrutinised. According to Magnan, there is a circular dynamic in fair value accounting, “with markets providing the input for the measurement of many assets, thus affecting reported earnings, which are then used by analysts and investors to assess a firm’s market value” and

²⁴ The Securities and Exchange Commission announced on 7 October 2008 additional details on the process and initial steps that the SEC has undertaken to conduct a study on "mark-to-market" accounting, as authorized by Sec. 133 of the Emergency Economic Stabilization Act of 2008, signed into law by President Bush. The study includes: the effects of such accounting standards on a financial institution's balance sheet; the impacts of such accounting on bank failures in 2008; the impact of such standards on the quality of financial information available to investors; the process used by the Financial Accounting Standards Board in developing accounting standards; the advisability and feasibility of modifications to such standards; and alternative accounting standards to those provided in [Financial Accounting Standards Board] Statement Number 157. Found at <http://www.sec.gov/spotlight/fairvalue.htm>

when markets are volatile, there is a knock-on effect on this circular chain (2009: 1).

However, the issue that remains is the question of whether private influence over international financial standards has helped harmonise 'pro-market' liberal regulations and the implication this has for the safety of global financial markets. For some scholars like Alexander, there is no question that the secretive and closed manner in which the BCBS conducted their deliberations allowed the excessive influence that banks had on the BCBS regulators, resulting in the BCBS G10 members to adopt weak capital standards for banks and "thereby bringing the world economy's fall into a serious economic recession" (2009: 881). The failure of the BCBS with its "opaque decision making processes" as well as other international financial standard-setting bodies to adequately "anticipate the virulent risks created in the financial system over the last ten years" highlights not only the role of regulators in the crisis but more importantly the international financial standards regimes (Alexander 2009: 881).

Private influence at this level of global policymaking is highlighted as an elusive but ever-present factor for contributing to the development of pro-market standards. In fact, prior to the onset of the crisis, scholars had argued for some time that international financial standardisation is a vulnerable area for market influence and capture, arguing that this setting "provide private interests with the opportunity to capture policy-making and regulatory processes in the financial domain and to influence the nature of monetary and financial governance" (Underhill and Zhang 2003: 84). These concerns form part of a wider literature which debates the role of private influence

over international financial standardisation. The remaining half of this chapter examines this literature, in order to establish the core assumptions made about the role of private actors in global financial standardisation. By assessing this literature, it argues that scholarship can be enriched further by examining how private actors are able to influence outcomes by establishing the causal mechanisms which lead to captured outcomes.

2.2 The question of influence: from state power, to transnational capture and private authority in international financial standardisation

From state power to a 'new world order'²⁵

Earlier accounts of international financial standardisation have focused on the primary role of the state in producing standards outcomes. These approaches encapsulate the way in which powerful states, their domestic institutions and domestic political pressures have influenced the production of international financial standardisation outcomes. Private influence in this literature is embedded within the domestic political economy, and standards outcomes at the international level of coordination are argued to be the result of state power (Kapstein 1994; Oatley and Nabors 2001; Simmons 2001; Singer 2004). This sort of approach on international policy outcomes was conceptualised by Putnam (1988) referred to as 'two-level games'. This is where at the national level, interest groups pressure governments to adopt favourable policies and governments create vested coalitions to enhance their power. At the international level, governments then seek to maximise their interests by pursuing these favourable policies in order to satisfy domestic

²⁵ From Slaughter (2004)

pressures (Putnam 1988). Private influence in this approach is seen through the lens of the domestic political economy, where private industry not only constitutes a state's economic power base but also where private actors help to shape a state's regulatory preferences. State actors are motivated by domestic political pressures and incentives, such as re-election or the preservation of office.

Private power or more practically the presence of private lobbying within the domestic political economy is one of the more common ways of conceptualising private influence in international financial standardisation. This conceptualisation of private influence is evident in one of the earlier accounts of the Basel Accord, where multilateral central bank cooperation was argued to be a case of bureaucratic self-preservation, where central bankers were attempting to serve several conflicting public and private sector interests in an effort to maintain if not enhance their positional power in their domestic political structures (Kapstein 1992). The Accord was not solely 'rigorous scientific investigation' but also reflected a political decision. The central bankers could have pursued other regulatory alternatives but many of these were dismissed as being politically unacceptable either to the banks or to elected officials (Kapstein 1992). In short, the story of international banking regulation suggests that "the political authority of existing bureaucracies (namely central banks) was increased, and the international response reflected in large measure the distribution of power capabilities" (Kapstein 1992: 268).

The creation of the Basel Accord is argued to be a primary example of the way in which politics underscored international financial regulation

(Oatley 2000). It has been argued that international financial regulation has little to do with correcting market failures that arise from international financial integration but instead, is concerned mainly with governments adopting international regulation to minimise the distributional consequences of regulatory reform in an increasingly integrated international financial system (Oatley 2000). In fact, the Basel Accord was referred to as an instance of 'redistributive cooperation' which is "the creation of an international institution that intentionally reduces at least one other government's welfare compared to the status quo" (Oatley and Nabors 1998: 36).

The reason behind redistributive cooperation is that domestic politics creates incentives for politicians to propose redistributive international institutions as a way of satisfying interest group and voter pressure demands without imposing costs on domestic producers. Hence politicians initiate international regulation that satisfies voter demands and transfers wealth from foreign producers to compensate domestic firms for the costs of the regulation (Oatley and Nabors 1998: 42). The 'regulatory capture' model could therefore be extended "to show how rational politicians operating in an open economy can have an electoral incentive to propose a redistributive international institution" and that the creation of international standards such as the Basel Accord "corresponds more to a redistributive rent-seeking than to a market failure logic" (Oatley and Nabors 1998: 37, 42).

International financial standards outcomes have also been modelled under a 'principal-agent' framework between the legislature and a regulator, for analysing regulator behaviour (Singer 2004). This approach emphasises

the idea that international standards and harmonisation is a political response to declining confidence in the stability of financial institutions and is a primary means of satisfying domestic political pressures. However, the principal-agent framework predicts that the regulator chooses a degree of regulatory stringency that falls within its 'win-set', which is the range of policy choices that do not result in legislative intervention. Exogenous shocks or voter confidence in financial stability decreases the size of the regulator's win-set and make intervention more likely. In these situations therefore the regulator has incentives to seek international regulatory harmonisation as a means of increasing the size of its win-set and safeguarding its autonomy. In short, "the regulator's domestic political environment prompts an international solution" (Singer 2004: 532-33).

These accounts emphasise the prerogative of domestic political pressures and incentives, but other accounts focus on the power of states in international financial standardisation forums. For example, harmonisation is said to occur within an international framework which involves strategic interactions between a dominant 'regulatory innovator' and the rest of the financial world (Simmons 2001). Explanations for how harmonisation unfolds fall into two dimensions. Firstly, the incentives other regulators face to emulate or diverge from the regulatory innovation of the dominant financial centre and secondly the nature and extent of the externalities produced by this reaction, as experienced in or anticipated by the dominant centre. Within this framework, US regulators can be thought of as unconditional first movers because the concentration of financial power in the US (in terms of the size of the internal US market) has profound

implications which give US regulators an incentive to make unilateral decisions even if foreign regulators don't follow suit. In this account, private influence is seen through US economic power to dominate the global regulatory agenda (Simmons 2001).

The great financial powers therefore remain the primary actors for handling the social and political externalities created by globalisation, with their preferences on regulatory issues firmly rooted in domestic politics (Drezner 2007). As the primary actors, Drezner (2007) argues that the great powers are consistently the most successful in achieving their preferences relative to others and will naturally prefer that global regulations mirror their own national standards as this reduces the adjustment costs. Non-state actors accordingly are important and can still influence outcomes "on the margins", but it can be argued that their interactions with states are more nuanced than the globalisation literature suggests (Drezner 2007).

These accounts conceptualise private influence as primarily embedded within the domestic political economy. Domestic political agents seek international solutions to satisfy domestic pressures. However, scholars have also recognised that international financial standardisation does not necessarily encapsulate unitary 'states' but rather agencies from within states engaging in informal policy networks. States in a paradigmatic sense still exist but it can be said that they are "disaggregated" along functional lines (Slaughter 2004). International financial standardisation is conceptualised as part of a 'new world order', which is "simply the rising need for and capacity of different domestic government institutions to engage in activities beyond their borders, often with their foreign counterparts" (Slaughter 2004: 12).

For instance, central bankers and regulators engaging in horizontal governance networks are argued to be the ‘new diplomats’, who have developed their own identity and autonomy in specific issue areas (Slaughter 2004: 11). Importantly, these networks are interacting with their foreign counterparts either abroad or above individual government institutions, and alongside more traditional state-to-state interactions through more formal international institutional channels (Slaughter 2004: 14).

This new world order has also been described as new forms of transgovernmentalism²⁶, which was conceptualised as direct interactions among sub-units of different governments not controlled directly by the cabinets or heads of state (Baker 2006: 6). The international financial architecture is characterised by a limited number of regulators and central state agencies that dominate and control global financial governance resulting in closed insider processes (Baker 2006). Unlike the state-led accounts, this strand of literature highlights the increasingly important role of private actors in global deliberations and forums. Private actors no longer remain “on the margins” but are instead at the forefront of developing norms which were once the prerogative of states (Drezner 2007, Cutler et al 2002).

A distinguishing feature of the new world order therefore is that global governance has realigned along functional lines, cutting across the territorial basis of political institutions “with a propensity to merge sub-national, national, international and supranational arenas” (Graz and Nolke 2007: 10). Furthermore, whilst the involvement of private market actors in global governance issues is not necessarily considered new, it is how some global

²⁶ The concept was originally developed by Keohane and Nye (1974)

private actors “have managed to develop a new relationship with the polity” (Graz and Nolke 2007: 11). The functionality of international financial regimes and the relationship these regimes have with a range of different private market actors are therefore crucial elements of the new transnational modes of governance.

For these reasons, research on transnational governance that encompasses both public and private elements is argued in this study to be a more fertile ground for exploring private influence in international financial standardisation than state-led approaches. This is because international financial standardisation is a type of governance which is not only undertaken by sub-units of different governments, but is also undertaken by private actors engaged in cooperation across borders to establish rules for their behaviour (Nolke and Graz 2007, Cutler et al 1999). Consequently, whilst domestic political pressures are still factors for consideration in standard-setting regimes that consist of government agencies with domestic regulatory imperatives, private standards regimes do not have the same types of concerns²⁷. The following sections therefore survey the literature on transnational governance and private authority, and examine the core assumptions made on private influence in international financial standardisation.

²⁷ This study will discuss the issue of private authority later in this chapter. Member firms or associations that interact at the global level may still have concerns for the domestic practices of their constituents but these are not considered the same as the political pressures faced by regulatory authorities.

Influence through transnational deliberation: private networks and global capture

Rather than seeing private influence as embedded within a domestic political structure, private actors from the major economic powers are identified as agents in their own right, acting on their own behalf in increasingly global networks. Private influence begins to transcend domestic national borders and is seen to operate directly at the global standard-setting level. There are three main features of this transnational literature which underpin private influence and ultimately policy capture. These are the actors involved, where this interaction is taking place and how private influence materialises through participatory and deliberative ‘spaces’ (Baker 2006, Underhill and Zhang 2005). It can be argued therefore that these transnational features generate captured outcomes because of the direct participation of private actors in these global forums.

A distinguishing feature of this transnational landscape is what is argued to be the emergence and expansion of both formal and informal decision-making forums that encompass both public and private elements “that cut across, constrain and jostle with states” (Cerny 2002: 194). Transnational modes of governance are likened to ‘webs’ of governance within and across borders, which involve complex interactions between markets, hierarchies and networks (Cerny 2002). Markets are said to have become entrenched not just as mechanisms to facilitate economic exchange but as “quasi-political governance structures in their own right deriving from the crucial systemic functions markets perform and the range of actors and transactions they encompass” (Cerny 2002: 198). The most market-based

sector is argued to be finance, and as a result the transformation of markets into governance structures has involved the development of new institutional forms and the emergence of highly significant private institutions for market regulation (Cerny 2002).

The development of these new institutionalised forms in international financial regulation include networks between senior officials from finance ministries and central banks, technical problem solving networks involving exchanges between regulatory specialists in specific issue areas, and multi-agency networks concerned with the system as a whole (Baker 2006). What makes these networks problematic is the limited number of actors involved in these forums. In fact, it is “the exclusive nature of participation in the global financial architecture that gives it its transgovernmental character” (Baker 2006: 22). Officials who participate in these governance networks are considered to be insulated from societal and political interests, because of the tendency of these officials to approach their work as merely a technical task (Baker 2006).

However, the growth in transnational modes of governance in international finance has also corresponded with a growth in the importance of transnational actors, particularly those from the private and business sectors (Mosley 2006). Whilst private participation in public policy is not necessarily new²⁸, regulatory officials and technocrats are said to have a more sympathetic relationship with those most directly involved in the international financial system which are the internationally active financial institutions (Baker 2006). This is because regulatory agencies are mandated

²⁸ See for instance Cutler (2002) who discusses the history of cartels by way of example.

to work with financial institutions to fulfil their supervisory functions (Underhill and Zhang 2003). Add to this a 'revolving door policy' between the largest international banks and regulatory agencies and according to Baker, we can begin to appreciate that technical consensus on how best to run a global financial system is far from politically impartial or neutral and "may actually disproportionately benefit a large number of internationally active commercial and financial interests...and unlikely to be representative of broader range of socio-economic interests and views" (Baker 2006: 24).

Private sector participation is therefore said to have become increasingly important in this transnational setting, where the close nature of interaction between public regulators and financial institutions has provided this sector with more opportunities to influence and capture policy making in monetary and financial governance (Underhill and Zhang 2003, Baker 2006, Mosley 2006). Consequently, private influence has produced rules and regulations which are created for the benefit of private market competitiveness, the result being "the emergence of 'market-based' approaches to supervision, where private firms are responsible for risk management through complex mathematical models implemented under the approval of supervisory agencies" (Underhill and Zhang 2003: 84). In these new webs of hybrid transnational governance, states are increasingly seen to be enforcement agents that are forced to integrate market-friendly norms and practices that both formal and informal transnational organisations come to develop as 'best practice' and 'benchmarking' (Cerny 2002). The content of regulation is therefore argued to have undergone a major shift towards 'pro-market re-regulation' and the principal benefits of this pro-market

transnational governance are expected to flow to the largest firms with an established transnational presence (Cerny 2002, Underhill and Zhang 2003).

The primary concern raised about these forms of transnational governance therefore is that the narrow, technocratic, closed insider policy process remains largely impenetrable to a wider range of concerned societal interests (Baker 2006, Underhill and Zhang 2003). Private actors in particular are said to have become as or if not more important than public regulators and this has left public regulators little choice but to realign their policy preferences to the preferences of powerful market actors. The finance sector is argued to have the determining influence on the rules governing its industry and “if finance is not satisfied with the policy output – attempts will be made to circumvent the policies until such time as the state accedes to its demands” (Harris 2004: 748). Consequently, international financial standards regimes “have actually become instruments of private economic interests rather than of the public good” (Underhill and Zhang 2003:86).

The problematic aspect of the nature of the policy communities responsible for making decisions in international financial standardisation was exemplified in the case of the securities standards regime, the International Organisation of Securities Commissions (IOSCO). In his study, Underhill argues that IOSCO is an example of transnational governance with “with extremely close ties to the industry they purport to supervise” (1995: 261). Regulators are becoming as concerned with financial competitiveness as with issues of safety and soundness, and in this environment, “greater levels of autonomy are necessarily conferred upon market actors” (Underhill 1995: 261). In fact, because regulators develop their policies in “commensurately

close consultation with market intermediaries”, the situation is argued to be “not far from classic regulatory capture” (Underhill 1995: 272-3).

In the case of the new Basel II Capital Framework, one key feature that has been highly scrutinised is that “the big banks have been able to pressure the Committee directly through comments and indirectly through representation to national banking authorities in order to prevent what they have seen as an overly burdensome new capital framework.”(Wood 2005: 149). Again, because of the close interaction between the BCBS and industry, the consultation and deliberation processes resulted in “drastic changes to the initial proposals for Basel II that have watered down the Committee’s proposals in a number of key areas” (Wood 2005: 123). Furthermore, where the big banks have refused to accept the BCBS’s proposals, Wood argues that the Committee has been forced to back down on a number of issues and thus “regulatory capture features as an issue...” (2005: 123).

Private participation in the formulation and implementation of regulation is highlighted as a primary reason for the changes made to the Basel II Framework but as Tsingou (2006) argues, this reasoning does not take into account the fact that private sector preferences have been internalised in financial policy processes. According to Tsingou, this has not happened as a result of conscious and deliberate strategy of capture. Instead, it is seen as the consequence of formal and informal practices of public-private interaction and agreement among an increasingly coherent and transnational policy community (2006: 56). This small elite group of private actors have had a pivotal role in shaping the interests of the BCBS as well as the agenda guiding the reform of the Basel Accord. Consequently, they have

in the context of Basel II acquired semi-institutionalised functions in the making of global rules which indicates that private preferences and interests are defining policy debates and restricting policy options and alternatives. Of more concern is that the influence of private sector participation is seen as legitimate (Tsingou 2006).

The financial regulators' dilemma is that they can never have accurate information about a bank's balance sheet, its exposure to off-balance sheet vehicles or its internal incentive structure. Regulatory capture is considered a fact of life and regulators everywhere and at all times have been at risk of being captured by the industry or private interest they are meant to regulate in the public interest (Buiter 2009: 38). However as already highlighted by Underhill and Tsingou, capture need not take the overt forms of bribery, blackmail, corruption but occur though "cognitive regulatory capture", which is "the process through which those in charge of the relevant state entity internalise and adopt, as if by osmosis, the objectives, interests, fears, hopes and perception of reality of the vested sectional interest they are meant to regulate" (Buiter 2009: 39).

In sum, transnational capture does not necessarily encapsulate the participation of private market actors *per se*, but the consequence that direct participation has on the internalisation of market norms, ideas and preferences within regulatory policy domains. Closed, narrow and exclusive deliberation and representation support the propositions advanced by Mattli and Woods (2009) that a limited institutional supply of global due process, characterised by closed and exclusive forums with minimal transparency, combined with weak demand for change because of suppressed information

about the social cost of poor regulation or failure of other demand side conditions will favour sustained regulatory capture. In their model, regulatory institutions which supply participatory mechanisms that are fair, transparent, and accessible and open (a case of 'extensive' institutional supply) are more likely to produce common interest regulation, however even in their opinion "these are difficult conditions to fulfil in global politics" (Mattli and Woods 2009: 4).

Influence through private authority and governance

The discussion so far on transnational private governance has focused on private actors participating in exclusive policy domains that are predominantly occupied by government officials, regulators and technocrats. Private influence is most evident in the way in which the underlying norms adopted by regulators are reoriented to be in the interests of market efficiency as well as stability. However, transnational governance also encompasses private actors cooperating outside the boundaries of inter-state or inter-regulatory coordination, producing their own standards for enforcement. This has resulted in private actors exercising 'authority' in governance at the global level, ultimately influencing the choice sets of states and the underlying paradigm of states as primary actors in the global system (Cutler et al 1999).

The development of private international regimes through the cooperation of firms, business associations and other corporate actors is considered to be significant because firms "are supposed to compete ruthlessly in the marketplace to attain the highest profits possible" (Cutler et al 1999: 7). Even though there again is nothing new in the cooperation of

firms (evident in the history of the formation of cartels²⁹) what is considered distinct from this idea of cooperation is that private cooperative arrangements are also increasingly engaged in authoritative decision-making “that was previously the prerogative of sovereign states” (Cutler et al 1999: 16). It is therefore the degree to which private arrangements act as a substitute for regulatory functions usually associated with the state which therefore raises important questions about the notion of private power in transnational governance (Cutler et al 1999, Graz and Nolke 2007).

There are two principal types of private authority evident in the literature, which are described as institutional market authority and normative market authority (Biersteker and Hall 2002). The former authority refers to the capacity of private actors to set standards that are recognised and adhered to by others, whilst the latter refers to the general acceptance of the idea that markets should determine decision-making over important issues (Biersteker and Hall 2002: 214). The former authority is generally more highly institutionalised than the latter, which are responsible for developing formal standards that are recognised officially (Biersteker and Hall 2002, Salter 1999). The operation of private formal standards organisations is likened to that of any formal bureaucratic organisation, where decision-making is organised in levels from the high-level policy meetings that make decisions for the organisation as a whole to the lower sub-group levels that are responsible for developing the technical standards (Salter 1999: 107-108). On the other hand, normative market authority is the more abstract form of authority that is less formally institutionalised but

²⁹ See for instance Cutler et al (1999)

more inherently based on the power of private norms infiltrating public policy agendas (Biersteker and Hall 2002, Sassen 1999).

Private arrangements and private authority therefore vary considerably, particularly in their degree of institutionalisation (Cutler et al 1999: 9). There is also debate over whether or not such authority has been delegated to private actors by states, where governments not only tolerate such arrangements but also welcome, legitimise and approve them (Strange 1996, Biersteker and Hall 2002, Pauly 2002, Sassen 2002). Given that there is such variation between the institutional and organisational forms of private cooperation, Strange (1996) argues that non-state authority can only be determined on the basis of outcomes. Private authority is significant where non-state actors exercise structural power where “any association, organisation or institution other than the state whose decisions indirectly affect the choices of others in society in ways comparable to that produced by the actions of state agencies” (Strange 1996: 91). Hence, whenever the choices open to others are changed, particularly when they are narrowed so that fewer choices are available “then it is likely that authority has been exercised structurally to produce that change” (Strange 1996: 91).

Above all, the transnational authority and power of private actors is seen to be a pervasive presence in global governance, where “the gravity of world politics has shifted during the last quarter century from public agencies of the state to private bodies of various kinds, and from states to markets and market operators” (Strange 1996: 95). These propositions raise a number of questions, which scholars still continue to grapple with (Graz and Nolke 2007, Biersteker and Hall 2002). The remaining sections of this chapter

highlight areas of the literature which may be enhanced by further empirical study in the area of international financial standardisation. This study aims to contribute further thoughts and empirical evidence to this literature, by focusing specifically on various forms of international financial standards regimes, their relationships and interactions with private market actors and how this affects outcomes by way of international financial standards.

2.3 Private participation, closeness and capture: the missing links

Reconciling participation, closeness and capture

Private actors participate in and are also said to have authority in new modes of transnational governance. At the extreme, this participation and authority is argued to exacerbate already narrow and democratically unaccountable policy processes, which leave public policy makers highly susceptible to industry influence and capture. However, an underlying weakness with this literature is the way in which scholars link participation and deliberation in policy processes with the outcome of capture, without addressing *how* participation and closeness in these forums generate captured outcomes. These approaches presume substantive outcomes as a result of the interaction between public and private actors. Private actors are said to have influence and authority but there is little discussion on what this influence constitutes and how it is exercised in order to produce captured outcomes.

For example, Tsingou (2006) raises the way in which the IIF, the global industry association for banks, played an active role in the drafting, revision and final version of Basel II. In her view, “the end result has been that the IIF preferences for market generated standards and market based

oversight solutions have been internalised in the Basel process, and that consequently large sophisticated banks are the best placed and best suited to the ensuing proposals” (Tsingou 2006: 62). Hence, the participation through drafting and revision to standards gives us some indication of how private influence affects outcomes. However Tsingou also makes the observation that “as part of the extensive consultation process, the IIF *along with a plethora of other actors (public and private)* was regularly sounded out and offered consistent feedback including providing expertise on highly technical issues throughout the process”(2006: 62) (emphasis added). This latter observation only leads to further questions about why the IIF preferences were internalised and the preferences and contributions of the “plethora of other actors” which were also sounded out for their technical expertise were not internalised. It also raises the question of why the BCBS regulators have no preferences and if they do, where they end up in the process.

The second underlying weakness found in this literature is that it does not recognise the varying ways in which private actors ‘participate’ in these standard setting forums. The three main strands of literature surveyed in this chapter for instance highlight three very different ways private actors are said to participate. In the first strand of literature, private actors can participate in influencing regulatory preferences through domestic lobbying channels. The second strand of literature highlights the ways in which private actors participate and deliberate directly in international regulatory processes, whilst the third strand of literature focuses on the way in which private actors participate as standard-setters engaging in broader governance

constellations. The key question that is raised therefore is whether all these forms of participation lead to the same captured outcomes.

The third strand of literature in particular raises an interesting conceptual dilemma of how participation can be reconciled with the concept of private authority, particularly institutional market authority that is directly responsible for developing formal standards that are recognised by other actors, including states. Private standards organisations are participating in the development of global norms within the broader concept of transnational governance, and they do so often with the explicit recognition given by states and other public agencies. However, there is very little analysis of how these private global norms come to be accepted as legitimate. Are they accepted as legitimate simply because states have delegated authority, and as such, left private organisations to their own devices? Or is private authority responsible for persuading public officials to buy in to the market-based discourse and if this is the case, how have they been able to do this?

One main criticism with the way in which the literature deals with private participation is that public actors are assumed to simply be vessels through which private influence passes. Becker has criticised this aspect of capture because politicians, political parties and even voters in their analyses “are assumed mainly to transmit the pressure of active groups” (1983: 372). Levine and Forrence argue that the main problem with capture theories generally is that they “do not explicitly consider the relationships among actors in the governmental process nor the mechanisms by which the acts of regulators are made to conform to the desires of organised sub-groups” (1990: 170). The interaction between public and private actors is assumed to

take place within a 'black box' where the institutional dynamics that constitute their relationship are often ignored (Levine and Forrence 1990). Furthermore, this interaction between public and private actors is also assumed to remain fixed or static and as a result, outcomes are expected to reflect the initial structure of interaction that was established in the first place. This does not contemplate the idea that relationships between public and private actors do not remain fixed, but develop and evolve in a process of interaction.

A prevalent theme surveyed in literature can be neatly summarised by the term 'cognitive capture' (Buitter 2009). This is an important aspect of the debate concerning capture in international financial regulation, because it brings us closer to what sort of captured outcome we are contemplating in this policy arena. However, the literature applies this concept of cognitive capture in much the same way as participation, where the norms and discourse of the market are again simply assumed to pass through public agents as though they were 'empty vessels'. Private actors are seen to pass cognitive influence on to public actors 'by osmosis' who then accept and adopt these norms and discourse (Buitter 2009). Cognitive diffusion and transfer in other words is understood as a one-way osmosis with little analysis on how private actors are able to influence the thoughts and ideas of public policymakers. The underlying weakness with this analysis is that the diffusion and transfer of norms and discourse between actors occurs as a two-way dialogue; the development of norms is a constitutive exercise where ideas and norms arise due to the interaction itself.

For instance, Underhill and Zhang (2003) make an important contribution to the debate by highlighting that public and private actors can have ‘shared world views’, which means that within their ‘symbiotic relationship’, public actors also have the opportunity and means to pass their normative ideologies and discourse on to private actors. The authors refer to instances where “private interests converted themselves into public and legitimated purposes through their successful integration into key policy processes” (Underhill and Zhang 2003: 771). Furthermore, Underhill has also importantly highlighted in his work on IOSCO that “achieving agreement in IOSCO is often an extremely arduous and conflictual process” and that “the road to an IOSCO agreement on capital adequacy has been a difficult one” (Underhill 1995: 263, 268).

This is an important recognition because it not only challenges the notion that actors adopt a wholesale acceptance of any norms, let alone private market ones, but also that the *process* itself is an interactive one where ideas, preferences and discourse are not simply taken for granted but instead are highly contested domains. If public and private actors shared the exact same ideas and preferences for private market norms and discourse for rule making, then the process for reaching agreement would not be an arduous one but instead one in which outcomes would be more easily achieved. The transfer of market norms from private actors to public authorities may indeed be occurring in their close interaction, but the main point to be emphasised is that this is only one-half of the dialogue which may be taking place.

Rethinking influence and institutional forms as causal variables

How does participation and authority lead to capture? Or how have private actors influenced policy to the extent that outcomes reflect market-based preferences and solutions? This study argues that the literature on transnational capture and private authority in international standard-setting can be enriched with a discussion about what private influence constitutes, and how it is able to capture outcomes. Participation and deliberation may constitute a form of influence, but this conceptualisation does not elaborate how closeness through participation enables capture. As such, this study seeks to identify the various forms of private influence, which can then lead to an examination of how they operate to capture outcomes. Core questions that this study addresses are how can private influence be detected in international financial standards regimes? Why are particular types of private influence evident in international financial standards forums? Do these forms of private influence lead to captured outcomes, or can private influence be evident without outcomes becoming captured?

This study posits that different forms of private participation are based on the same fundamental dynamic, which is the supply and demand of private capabilities. Private influence is evident in different standards regimes because the existence of particular types of private capabilities will depend on the demand by public policymakers for that type of private input. This framework of analysis therefore re-introduces public policymakers and regulators as dependent variables that play a critical and active role in facilitating the transmission of particular modes of private influence based on a demand for power. However, it also posits that because private influence is

based on public demand, private influence may also be constrained and curbed by regulators using the same mode of power acquired from private actors.

How does this occur? Private influence and its interaction with public agencies does not occur in a vacuum but instead takes place within institutionalised boundaries. The different approaches to institutional theory helps us to see that whilst institutionalised structures are a critical variable in shaping and constituting the supply and demand relationships between public and private actors, the role of agency is also important in a study of influence by assessing how the institutional infrastructure can be used to facilitate and constrain relationships within those boundaries.

The question that is raised is whether these transnational modes of governance are distinct from other formal international organisations and if so, whether these distinctions are contributing or enhancing the ability for private actors to exercise their power. Scholars such as Baker (2006) have noted such attributes as the unrepresentative composition of standard-setting regimes, narrow and closed policy processes, exclusive deliberation with private actors and the lack of any form of accountability. These attributes are therefore examined to decipher whether and how these institutional characteristics contribute to private influence over outcomes.

Exclusive interaction with private actors through narrowing the institutional representation of standard regimes is hypothesised in this study as a strategy for enhancing the 'supply and demand' power relationship in place, which at the same time enables public policymakers to constrain private actors if they are perceived to be encroaching on their authority.

Closeness therefore is characterised as a conditional closeness, enforced through the institutional mechanisms that are tailored to include private actors when the demand for private power is high, and exclude private actors when the demand for private power is low. The outcome of the supply and demand power relationship, within narrow and closed institutional contexts would therefore generate outcomes that encapsulate both public and private interests. These institutional features therefore may be used as intentional mechanisms by public agencies to not only facilitate their close relationships with private actors, but to also curb private influence when their own authority is perceived to be under threat.

2.4 Conclusion

As surveyed in this chapter, international financial standardisation presents some considerable analytical as well as practical issues. The expanding scope and proliferation of financial standardisation not only raises questions about the legitimacy of these technocratic agencies in global financial governance but more importantly for this study, also raises concerns about the role private market actors play in governing financial activity. The underlying concern raised by critics is that private market actors not only influence governance outcomes but they also influence the public figures who are supposed to protect broader public interests. The question that this study intends to address therefore is whether international financial standards bodies have indeed been 'captured' by private interests and if so, what implications this has for the 'winners' and 'losers' in global financial markets. The remainder of this study proposes an alternative framework for understanding the dynamics of public-private interaction, namely by way of

introducing an institutional framework of analysis that offers a much more comprehensive means of assessing whether a captured relationship necessarily produces captured outcomes. The study will then apply this framework to three comparative empirical cases and conclude based on the empirical findings.

3

Private Influence in International Financial Standardisation: analysing the institutionalised supply and demand of private power

Private influence in international financial standardisation is conceptualised by scholars as part of a broader issue involving the role of private actors in new modes of transnational governance (Baker 2006, Nolke and Graz 2007, Cerny 2002). Central to these debates is the notion that private actors and public policymakers interact in close and exclusive policy settings, which allow private actors to influence and capture policy outcomes. Whilst these debates provide important insights to the study of private influence, an underlying weakness found in the literature is that it pre-determines both outcome (captured outcomes) and causality of outcome (private influence) without addressing the causal mechanisms which lead to a situation of private capture. Given the important ramifications of these arguments for the ongoing legitimacy of international standards regimes, this study argues that more attention is needed to establish the theoretical and empirical links between private influence and policy outcomes.

This study proposes an analytical framework that sets out how private influence operates in international financial standard-setting and the circumstances under which influence does and does not determine decision outcomes. This framework incorporates important theoretical contributions already made in the literature on power, economic regulation and institutions

but combines these insights to provide an explanation for how private influence operates and affects outcomes in these international financial standards forums. It does so by examining what private influence constitutes and the reasons for why private influence is evident in international financial standard-setting. It firstly proposes that private influence is part of a 'supply and demand' relationship where regulators demand private power capabilities to enhance their own policy or political needs and private actors willingly supply these capabilities to influence outcomes. It argues that captured outcomes as a result of this relationship are likely to arise when demand for a specific private capability is high; that is, when regulators are not able to fulfil their regulatory roles and policy requirements without private power capabilities, due to the specialised and technical nature of specific regulatory issue areas. On the other hand, captured outcomes are not likely to arise when demand for private capabilities is low. Demand for private power may be low when private power capabilities have fulfilled the regulator's initial purpose, or when regulators perceive the capability to be a threat to their political and/or policy-making authority.

However, whilst these factors outline the reasons why influence and capture may arise in international financial standardisation, they do not provide for *how* supply and demand relationships produce outcomes that are captured or not. As a result, the study's central thesis is these relationships are bound by institutions and as a result, private influence may be enhanced and/or constrained in institutionalised settings. Specifically, whilst institutional structures will constitute the supply and demand dynamic between regulators and private actors, regulators will attempt to use

institutional mechanisms to include private actors when the demand for private power is high, and exclude private actors when the demand for private power is low. This means that whilst institutions can facilitate capture, they can also frustrate and constrain private actors from producing outcomes which are favourable to their vested interests. As a result, standards outcomes are likely to encapsulate both public and private interests, the extent of either depending on the supply and demand dynamics interceding with institutional mechanisms.

3.1 Why private influence? Explaining the supply and demand of private capabilities

Private influence in international financial standard-setting

In order to attain an understanding of how international financial standards are influenced by private actors, it is necessary first to understand what private influence is and the nature of the power that private actors possess in international standards-setting in order to obtain political objectives or goals (Fuchs 2005). Private market actors as agents of capital are said to exercise 'power' in the political arena but as Fuchs (2005) argues, this power is frequently referred to in popular literature in terms of the size of firms or their market share in certain market segments. Whilst this identifies characteristics of those private actors, it does not tell us how private actors use those characteristics in a political arena and whether those characteristics alone give private actors the power to construct or change political outcomes. Consequently, private influence must be assessed as the power of private actors "to pursue successfully a desired political objective" (Fuchs 2005:774).

In international financial standardisation, the objective is to influence the content of standards. This is because the creation of an international financial standard is about the creation of norms, or how authorities should regulate their financial institutions and how financial institutions should behave in accordance with those principles. At the very heart of what an international financial standard should look like is a fundamentally normative process concerning ideas. The ideas that actors hold will affect how they define their interests and preferences in the first place. Therefore, private actors will attempt to influence the ways in which policymakers understand how to govern and regulate international financial market activity, which in essence is the way in which private industry would like to be governed in accordance with their private market principles.

There are three main approaches to power in international relations which help to inform our understanding of private influence. These are firstly the 'instrumentalist' perspectives, which emphasise the ability of private market actors to act cohesively in the political arena to pursue to political goals, using largely their material resources; secondly the 'structural dependency' approaches which emphasise the dependency within a market system that the state has on private sector activity and profitability; and finally the cultural or discursive approaches, which focus on the ideological paradigms that private market actors generate based on their private sector activity (Levy and Egan 2000). Private actors therefore possess and employ these three sources of instrumental, structural and discursive power capabilities in political arenas to influence political activity. This chapter will discuss each source of power briefly, but concentrate on one form or 'face' of

power which is most relevant to the 'supply and demand' proposition outlined in this study: instrumental sources of power.

We begin with this first 'face' of power as it is the most overt form of influence and one that is often associated with private market actors because of its emphasis on instrumental causality on outcomes where the power of private market actors can be assessed in policy or decision outputs. Private market actors can influence international financial standards by exercising 'instrumental power' where 'A has power over B to the extent that he can get B to do something that B would not otherwise do' (Lukes 2005a: 16). Instrumental power is also frequently associated with private actors because it is linked to the ability of private actors to utilise their specific human, organisational or financial resources as well as their close access to decision-makers (Fuchs 2005). Instrumental power, through such tangible forms as material resources, is a crucial part of the power 'arsenal' that private actors have available to them. In fact, it is the ability of private actors to use and devote their resources to their wider political objectives such as taking part in international policy initiatives and other forms of business and political 'roundtables' that provide them with exclusive and privileged access to decision makers in the first place (Fuchs 2005: 781-2).

Prevalent examples of instrumental power include private lobbying and political and campaign financing where corporations and business associations not only join forces at the domestic level of politics to lobby politicians but are also organised as transnational networks that lobby in all international arenas of strategic importance (Fuchs 2005). This is an important source of private market power in international financial standard-

setting because of the need to employ the human and material resources to respond to policy proposals and where possible lobby directly at international forums. The rise of international financial associations such as the International Institute of Finance (IIF) who are mandated by the world's largest financial institutions to lobby and respond to policy initiatives of the various international financial policy arenas is one example of the exercise of instrumental power³⁰.

The ability of private actors to devote their resources to generating information and using this information is also another example of instrumental power in policy arenas. Policymakers in international financial standard-setting may rely on private market actors for information that they in turn rely on for policy input. For instance, regulators will often be in situations where there is an asymmetry of information where they rely heavily on the information provided by the financial sector regarding their own activities. Moreover, due to resource pressures, regulators may also rely on the ability of the finance sector to dedicate more time and resources to collecting and assembling that information that regulators would otherwise need to undertake. The technical complexity of financial activity and correspondingly, the rules needed to regulate that activity is one of the reasons why it is argued the finance sector has a 'special' status among stakeholders in regulatory and policy deliberations.

In addition to instrumental power, private market actors also have a less overt form of influence where states have a structural dependence on

³⁰ I discuss the IIF and its role in the Basel II process in more detail in Chapter 4. The IIF has for instance been singled out by scholars such as Tsingou (2006) for having disproportionate influence over the Basel II policy process.

private sector activity. Specifically, instrumental sources alone “fail to capture the potential influence that the dependence of political elites on private sector profitability has on political agendas and policy options” (Fuchs 2005: 775). As the main source of economic productivity and growth, it can be argued that business has a kind of ‘silent’ power over policymakers because of their need to ensure that regulation does not unduly burden business interests and profitability (Falkner 2008). This is particularly pertinent for global financial policymakers who are well aware of the systemic risk that global financial conglomerates pose for the global economy, as highlighted by the global financial crisis.

This structural power is what Bachrach and Baratz argued to be the power of ‘non-decisions’ or as they argue, “to the extent that a person or a group – consciously or unconsciously – creates or reinforces barriers to the public airing of policy conflicts, that person or group has power” (1962:949). Even though power is thought to be exercised in decision-making when A participates in the making of key decisions that affect B, power is also said to be exercised when A can also effectively prevent certain issues from reaching a decision agenda (Bachrach and Baratz 1963). Structural sources of power can therefore predetermine the behavioural options of political decision-makers through existing material structures which then allow private actors to determine suitable alternative solutions before actual and observable bargaining is undertaken (Fuchs 2005). An example of structural power in the case of financial regulation is that certain regulatory policy options might not even be considered due to the implications of such decisions on financial sector profitability. At the global financial policy

setting level, these options might also not be considered because of broader global systemic stability considerations.

These sources of power neglect yet a third source, which is argued to pre-exist these first and second dimensions of power. Private market actors also have the power to shape the preferences and desires of actors which can then shape the direction in which decisions and non-decisions take (Lukes 2005). In an international forum such as financial standard-setting, where the political objective is to determine the underlying norms understood by policymakers, the exercise of this power source is critical. Specifically, “A may exercise power over B by getting him to do what he does not want to do, but he also exercises power over him by influencing, shaping or determining his very wants” (Lukes 2005: 27).

Power in this respect is seen to be a function of norms and ideas and is captured by sociological and discursive perspectives on power relations in a political process. Actors engage the strategic use of discourse to shape the norms and ideas of others and therefore policy decisions are not just a function of resources, or structural dependencies but “is a function of discursive contests over the frames of policies” (Fuchs 2005: 777-8). The third dimension of ‘discursive power’ is a crucial source of power because it can enhance an actor’s instrumental and structural power (Fuchs 2005). Whilst instrumental and structural power are fundamental for getting private actors to a privileged position at the policy bargaining table, discursive power is then pivotal in influencing the nature of policy decisions through the ability to shape underlying norms.

Private market actors exercise their structural power by being able to provide information that public actors do not have access to, however, instrumental and structural power alone may not necessarily influence the way in which that information is then subsequently used by policymakers. Instead, discursive power is the ability of actors to frame that information, so that policymakers adopt the underlying normative values that actors wish to diffuse. Put simply, it is not only about influencing how policymakers should understand financial market regulation but also the underlying function financial regulation should have in financial markets. ‘Technical’ knowledge in this line of argument, or knowledge which is said to be based on empirical fact, may not be technical or empirical at all, but rather the ability to convince others that such information is ‘right’ and ‘objective’. Hence “regulatory discourses are thus strongly influenced by the discursive power of firms rooted in their privileged economic position” (Falkner 2007: 32). Importantly, discursive power is crucial in a normative or policy-making arena, because it is in a policy-making environment that the most influential discourse prevails through to policy outcomes.

Private influence can be seen through instrumental, structural and discursive frameworks and all three faces of power are crucial for understanding the context within which private influence emanates, is constituted and exercised. It is difficult to disaggregate these sources of power because they are ‘faces’ of one multi-faceted phenomenon, interlinked in their purpose, which is the shaping of outcomes. Furthermore power is not only multidimensional – taking on both visible and invisible forms – but must also be contextualised and studied in specific policy domains. Empirical

context is crucial in the analysis of private power as an empirical analysis would highlight that private actors may have greater propensity to influence with only one of these sources of power as opposed to others (Falkner 2007).

For this reason, this study explores how private actors influence international standard-setting arenas using instrumental sources of power. This is because in regulatory policy arenas, there is often a fundamental asymmetry of instrumental power capabilities, in the form of resources, information and expertise. This asymmetry therefore precipitates the functional regulatory need for these forms of capabilities, thereby creating the conditions for 'capture' through close interaction and participation in regulatory policy domains. This is otherwise referred to as the 'supply and demand' of private capabilities, which is discussed further in this chapter. Private instrumental capabilities may therefore secure private actors a privileged position at the policy bargaining table, often precluding other stakeholders from participating in these forums. The need for and provision of private instrumental capabilities therefore is proposed to be the functional rationale of private influence in international standard-setting arenas.

The conditions for capture: the supply and demand of private power

Private actors can exercise instrumental sources of power in regulatory policy arenas to pursue strategic objectives but the exercise of this power may not necessarily be forced upon unwilling recipients. It may not, in other words, always be the case that "A has power over B to the extent that he can get B to do something that B would not otherwise do" (Lukes 2005a: 16). One of the core tenets of the theory of economic regulation is the supply and demand of regulation. Importantly, both public policymakers and private market actors

engage in close relationships because they are ultimately rewarded by such a mutually beneficial exchange. The theory of economic regulation advanced by Stigler begins from the premise that regulation is not necessarily rational and indeed “the problem of regulation is the problem of discovering when and why an industry (or other group of like-minded people) is able to use the state for its purposes, or is singled out by the state to be used for alien purposes” (1971:4). Stigler goes on to argue that “as a rule, regulation is acquired by the industry and is designed and operated primarily for its benefit” (1971:3).

The theory of economic regulation is therefore based on a ‘supply and demand’ model where public actors essentially incur costs for enacting legislation or policy – “costs of operation, costs of maintaining an organisation and competing in elections” (1971: 12). As a result, Stigler argued that the industry with the most interest in obtaining favourable regulation “must be prepared to pay” with two things political actors most needed – votes and resources (1971: 11-12). Consequently, Stigler’s model of regulation is based on the transaction costs between self-interested suppliers – that is, legislators, executives and their regulatory agents – and self-interested demanders, which determine the regulatory outcome (Peltzman 1993:822).

This supply and demand model is an important theoretical contribution that warrants more attention in an analysis of private influence. This model provides important insights into the reciprocal aspects of instrumental power, where instrumental power not only takes on different forms but can also be understood as a resource which is exchanged in a

political marketplace. By adopting this premise, public actors are no longer passive agents subjected to private power but instead are active instigators seeking to 'sell' their policies and legislation at a cost. Private market actors therefore calculate the costs of providing these resources against the cost of uncertain or unfavourable regulation and determine that it is much more beneficial to provide the resources than to pay the 'deadweight losses' from acquired regulation (Stigler 1971, Peltzman 1993). At the heart of private influence in economic regulation therefore is an incentive for both parties to engage in such mutually beneficial interaction, to the exclusion of other interested parties and or stakeholders. The exchange of power capabilities is considered valuable to both parties because it ultimately enhances their positions of power. The result can be what is referred to as 'regulatory capture' which is "the triumph of the cohesive producer interest over the diffuse consumer interest" (Peltzman 1993: 823).

This study however takes a slightly different approach to the supply and demand model advanced by Stigler (1971) and argues that private actors don't exercise power but instead supply power to policymakers who have a demand for it. This means that private actors supply various instrumental capabilities because it enhances their leverage for obtaining favourable policy outcomes. Public regulators and policymakers also use these sources of power to enhance their own political standing or professional security. Such a relationship can therefore create a 'win-win' for both sides. Furthermore, this study also proposes that capture does not occur simply because there is a supply and demand relationship between regulators and private industry, but when demand for a specific private capability is high; that is, when regulators

are unable to fulfil their regulatory roles and policy requirements without the input of private power capabilities. This demand is accentuated by the fact that financial regulation can be highly technical and policy development relies on a limited number of specialists with the required knowledge. Because this specialised knowledge is largely developed and generated by markets through financial product innovations, private actors involved in these technical areas are considered to have the most capabilities when it comes to dealing with these issues.

When this asymmetry of power occurs, regulators will consider that the benefit from the use of private power capabilities outweighs the cost to regulators of not having these resources at all, or the cost of generating the capabilities themselves. However, this study further argues that regulators will only seek the use of private power capabilities if these capabilities are able to help regulators undertake their mandated tasks, thereby enhancing their positions of political and /or policy-making authority. If their positions of authority are enhanced, regulators will use the private power capabilities favourably in order to produce the required regulation as well as provide private actors with the incentive and pay-off they are ultimately seeking through favourable policies and regulations. This is argued to constitute the captured 'win-win' condition for both parties.

Based on this theoretical approach, private capture in international financial standards regimes would involve two variables: firstly, when regulators are in need of a power capability and actively seek it from the most dominant private actors within the industry; and secondly, those dominant private actors within the industry provide that capability. Examples of such

'supply and demand' would include for instance the supply of material sources of power through political and campaign financing in exchange for a privileged position at the bargaining table. Public actors may also for instance depend and rely heavily on the information provided by private actors of their own activities. Moreover due to resource pressures, public actors may also rely on the ability of the private sector to dedicate more time and resources to collecting that information that public actors would otherwise need to undertake. Finally, private actors may also be better equipped to provide technical 'expertise'. Technical knowledge in this line of argument, or knowledge which is said to be based on empirical fact, may not be technical or empirical at all, but its 'ready to use' format may be more convenient for public actors to consume than developing this technical knowledge themselves, making it again less costly to develop legislation.

However, where this study fundamentally diverges from the theory of economic regulation is the presumption of outcome. The outcome of the supply and demand model within the theory of economic regulation is that regulation acquired by the industry is designed and operated primarily for its benefit (Stigler 1971). Transferring this to the argument presented in this study, this means that regulatory capture is based on a continually high demand from regulators for private power capabilities. Whilst this may indeed be the case, it still fundamentally neglects the possibility that regulators may not always have a high demand for private power capabilities and in fact, may choose to design and operate regulation that is not beneficial to private interests.

For instance, if we take the example of the political actor accepting the campaign funding from a private constituency, this does not in itself guarantee that policy outcomes will reflect the preferences of that private constituency. We can only assume that the acceptance of private material resources would ensure a place at the bargaining table. Likewise, the collection of information from private actors does not tell us anything about the subsequent *use* of that information by policymakers. Information by its very nature can be reformulated to the point where it no longer resembles what was initially collected. Similarly, information that has been provided by technical ‘experts’ does not in itself ensure that this expertise is either used or adopted in final policy decision outcomes. It may influence how regulatory actors think of and address a particular problem, but the same expertise may not be adopted in other policy decisions.

Why would this occur? Why would there be instances where outcomes are not captured by private interests, even when regulators utilise private capabilities? We can surmise that demand for private power capabilities is high when regulators are dependent upon the private power source, but this demand may also fall when the capability has fulfilled the regulator’s initial purpose, thereby reducing the utility of that power source. The regulator may therefore choose to use the power source to enhance its authority, and once the regulator’s task has been fulfilled and authority has been achieved, demand for private power capabilities may then wane. Demand for private power may also fall when regulators perceive private power to be a threat to their authority. The reason for this perceived threat is that because regulators lack certain power capabilities, and private actors are able to provide these

capabilities, regulators may assess that the cost of acquiring private capabilities outweighs the benefit that it could potentially provide in the initial transaction costs associated with implementing policy and legislation. The self-interest of regulators to preserve their control over policy-making in this instance is greater than the uncertainty of not being able to produce the required regulations.

This supply and demand dynamic between public and private actors is argued by this study to be accentuated in transnational policy arenas for two main reasons. Firstly, the technicality and complexity of financial products that are transacted on a global basis means that there are fewer private market participants with this highly specialised knowledge, making ‘supply’ limited. Secondly, the uncertainty of what constitutes the political and or policy-making authority of regulators in these informal global deliberations creates conditions that are both more and less conducive to seeking power capabilities from such a limited supply of private sources. Unlike the formal mandates given to them by domestic legislative mechanisms, regulators in international financial standards forums are there as voluntary members and as such, have no legislated ‘authority’ to exercise over transnational private actors.

The informality of the standard-setting mandates is, for example, most clearly exemplified by the Basel Committee on Banking Supervision (BCBS), which categorically states that it “does not possess any formal supranational supervisory authority” and its conclusions were never intended to have legal force. Instead, the underlying basis for the BCBS is to “encourages

convergence towards common approaches and common standards”³¹. It is for this reason that the perception of authority in these settings largely relies on the contributions of members. Private power capabilities therefore may initially enhance and boost the authority of regulators in these global forums by providing these resources, but because authority ultimately rests on legitimacy, they can also ultimately threaten the policy-making positions that regulators assume in financial standardisation.

The relationship between international regulators and transnational private actors is therefore one that rests on a limited supply and competing demands. Whilst it may be in the interests of both parties to engage in close and cooperative exchanges to produce outcomes that are beneficial for the status and authority of both parties, this may not always prove to be the case. This is because the uncertainty of the authority that regulators hold in these transnational forums generates political insecurities amongst regulators. Under these conditions, regulators will be motivated more by self-preservation than mutual gains and as a result, private capture of policy outcomes is not guaranteed. The question that remains is how do outcomes arise as a result of either a high or low demand from private suppliers?

The core contention of this study is that because regulators lack formal mandated authority in the transnational global policy arena, they not only use private power capabilities to enhance their own positions of authority but also attempt to curb private influence, using primarily institutional mechanisms. These institutional mechanisms are used as a ‘substitute’ for the domestic legislative authority which regulators lack in the transnational

³¹ Refer BCBS History at <http://www.bis.org/bcbs/history.htm>

governance arenas. The remaining half of this chapter discusses the linkages between the supply and demand relationship between public and private actors, and the institutional environments that bind, enhance and constrain the way in which this relationship generates policy outcomes.

3.2 Private influence and private capture: enhancing and constraining private power through institutional mechanisms

Explaining the structure and agency of institutionalised supply and demand

One key question raised in this study is *how* private actors capture international financial standards outcomes. This study argues that private actors are able to capture outcomes if there is a high demand from public regulators for a specific private power capability, and alternatively, not able to capture outcomes if demand from regulators is low. Whilst this provides the reasons why capture may or may not be possible, this still does not explain the operation of how outcomes become captured or become prevented from being captured.

One of the problematic issues raised in the literature on transnational governance is the exclusive nature of these closed policy environments. Their composition and deliberative processes are said to be narrow, and impenetrable to the wider public, leaving important issues of public regulation to be undertaken behind closed doors (Baker 2006, Underhill and Zhang 2003, Cerny 2004). The question that this raises is whether “blurring the boundary lines between public and private, indeed, is part of an intentional effort to render opaque political responsibility for the wrenching adjustments entailed in late capitalist development” (Pauly 2002: 77). Were

these institutional features an ‘accident’, or have they been intentionally built to achieve something other than global standards for ‘best practice’?

This study hypothesises that these institutional features of exclusivity and the “blurring the boundary lines between public and private” have been reinforced by the path-dependent nature of the ‘supply and demand’ relationship between public and private actors in contemporary international financial governance. The relationship has been fostered by the pace of change in global finance as discussed in Chapter 2, which has then created and sustained these institutional features, which in turn propels the relationship to generate the output required by these new modes of governance.

This study further proposes that these features are an important means for public regulators to not only foster their supply and demand relationship with private actors but to also enforce their authority through these institutional means. The narrow and exclusive institutionalised features of these forums means that it is much easier to exert ‘control’ and to manipulate outcomes with fewer interests than it is when there are broader constituencies to take into account. The supply and demand relationship has therefore evolved itself with structures and processes in place to ensure that strategic supply and demand between these two parties works so that private actors can provide their input based on the specific capability required and regulators can produce the required standards.

Institutional theory provides us with two variables that help us to understand how and why international financial standardisation has formed in this informal manner: firstly, institutions that are viewed as systems or

structures which bind and constrain agents as well as predefine their ideological dispositions; and secondly, institutions as processes generated and negotiated by agents who are constituted through their common social interaction, giving rise to distinct organisational norms and identities.

At the very simplest level institutions can be considered systems that define the context within which actors operate and interact with one other (Campbell 2004). Actors choose to work collectively to achieve their goals because the development of such an organisational form is said to reduce the transaction costs by facilitating exchange between parties (Campbell 2004, Hall and Taylor 1996). Furthermore, once firmly established, organisations are said to develop and assume their own distinct identities, making them independent of their founders or those who constitute their membership (Reed 1992). This concept of organisation emphasises the organisations' characteristics of being goal-oriented, purposeful and constituted through the way in which it is geared to the functional needs of the system (Reed 1992). The result is argued to be an ongoing tension between the organisation's demands and the needs or interests of its individual members (Reed 1992).

Organisations seen in this light are therefore seen as structures above and beyond its individual members, possessing "an independent logic of their own that be isolated and analysed without reference to social actors and the shared meanings through which they frame on events" (Reed 1992: 93). However, it can also be argued that organisations are reflections of the macro-configurations of power, which are geared towards the advancement of the dominant economic, political and social interests prevailing within the societies of which they are part. Specifically, formal or complex organisations

are seen as tools or mechanisms through which dominant groups secure and maintain the conditions necessary for their social reproduction and survival over time (Reed 1992). For this reason, some scholars argue that states as actors of the international polity for example spend a great deal of time and effort, and even fight over the construction and design of institutions precisely because institutions in their own right can advance or impede state goals and thus affect outcomes (Koremenos et al 2001).

When this occurs, organisational structures and practices create biases which automatically favour not only dominant interests but also underlying ideological assumptions and values such as 'rationality' and 'efficiency' (Reed 1992). As a result, "the institutional structure builds in a set of constraints with respect to downstream changes that biases choices" (North 1998: 20). Furthermore institutional structures are also 'path-dependent' where path dependent processes mean that "history is remembered" and once a particular path is established, "self-reinforcing processes are prone to consolidation or institutionalisation" (Pierson 2000: 75). For this reason, it can be argued that path dependence structures the way in which the preferences and the interests of actors are shaped because an actor's rationality is constrained by how they think about time. Actors are therefore seen to have a 'bounded' rationality, a rationality that is limited by that actor's worldview, meaning that individuals will often turn to established routines or patterns of interaction that are familiar to them in order to attain their purposes (Hall and Taylor 1996: 939).

The implication of deeply embedded path-dependent organisational structures and the resultant bounded rationality is that any fundamental

change to the status quo is difficult to achieve without endemic conflict and “the uneven struggle between dominant and subordinate groups to exercise some degree of control over the conditions through which organisational existence is secured – is the primary source of structural change within complex organisations” (Reed 1992: 94). On the other hand, if private actors are supported by the dominant power groups which have established and reinforced the structural conditions in favour of their interests, private influence is evidently enhanced by these structures. However, the structural approach treating the organisation as a tool or a strategic venue in which “contending class or group interests slug it out and rationally manipulate internal structures and practices according to their sectional interests” is criticised by sociologists for treating the organisation like a black box (Reed 1992: 103). For this reason, sociological institutionalists stress the importance of the social mechanisms of norm diffusion which generates patterned and institutionalised interaction.

This then leads to the second institutional variable that focuses on the role of agency in the construction of organisations as symbolic or cultural forums. The structural boundaries of institutions are in this approach the manifestation of the collective values and the organisational cultures which are shaped by the collective experiences and meanings given by the organisation’s members (Reed 1992). Institutions are, in short, “systems of meaning” providing routines, symbols or scripts and hence are ‘templates’ for behaviour (Peters 1999, Hall and Taylor 1996: 948). As a result, institutions affect an actor’s perceptions of what is appropriate practice and “individuals who have been socialised into particular institutional roles internalise the

norms associated with these roles, and in this way institutions are said to affect behaviour” (Hall and Taylor 1996: 948). Institutions are said to have normative influence not only in the way in which actors believe they should behave in a given context but also a more cognitive influence, “by specifying what one can imagine oneself doing in a given context” (Hall and Taylor 1996: 948). Actors therefore derive meaning, as well as their identities from the institutional context in which they interact, and in this way institutions are said to not only affect the strategic calculations of individuals but also their understanding and interpretation of their preferences and roles within institutions (Hall and Taylor 1996).

At the heart of this approach is the internal culture of the organisation which becomes “the basic resource and process through which social action and interaction are continually constructed and reconstructed to form a shared ‘organisational reality”” (Reed 1992: 105). This means that organisations “simultaneously support and question dominant structures of meaning, power and control” because dominant cultures may try and frame the symbolic creation of ‘rational’ discourse but ultimately the acceptance of such an organisational reality is dependent upon its socialised members (Reed 1992: 107). The implication is that private influence can either be constrained or enhanced by certain ‘cultural’ elements such as values, norms, constructed rules, beliefs and taken-for-granted assumptions, defining “the way the world is and should be” (Barley and Tolbert 1997:93). Institutions are therefore argued to influence how people communicate, enact power, and determine what behaviour to sanction and reward primarily because institutions encode interactions where actors simply behave according to

their perception of the way things are done within that organisation (Barley and Tolbert 1997). Institutions therefore establish normative 'ways of doing things' which actors conform to, even if actors consciously become aware that it is not their interests to follow such norms.

As a result of both agency and the overall structure of dominant financial powers engaging cross border cooperation, the exclusivity of the transnational standards-setting environment not only becomes the norm but also begins to reinforce and justify the functionality of the supply and demand relationship between public and private actors. Agents within these settings therefore become so engrained in the environment that having specialised relationships with stakeholders is part of the dominant culture established within these forums. These environments also determine the ways in which relationships between public and private actors are undertaken, and as a result, both regulators and private industry actors come to be aware of their roles and expectations of behaviour. These modes of interaction in transnational governance are therefore geared towards generating exclusive outcomes, which can otherwise be justified as 'efficiency gains'.

Enhancing and constraining private influence through institutional mechanisms: enforcing demand-side authority

Institutional theory gives us two important variables for understanding how relationships can be enhanced or even constrained in their ability to produce outcomes. This study hypothesises that the exclusive nature of transnational governance, empirically characterised by international financial standard-setting institutions, has come into existence because of the underlying nature

and dynamic of the supply and demand relationship between regulators and private actors. However, this study is also interested in the agency of action which underpins the supply and demand incentive structure. Agency here is characterised by the way in which agents, in this case regulators, can utilise the institutional infrastructure in a way that supports the supply side of their relationship with private actors, but also simultaneously supports the demand side of regulatory authority and power over standards outcomes. The study is in other words interested in ascertaining how capture operates within institutional boundaries.

In the case of international financial standardisation, this study argues that standardisation has three institutionalised characteristics that are critical to the way regulators conduct and enforce the demand-side of their relationship with private actors. The first is that international standardisation is an exercise in the creation of norms, which means that actors battle to manipulate the language and methodologies of those standards so that the ultimate benefits flow to those who create the norms. The second characteristic is that the creation of norms can be dependent on policy-making processes, which can significantly alter decisions along the policy-making path. This means that the content and creation of norms can be reconstructed. Finally, standard-setting occurs within collective decision-making structures, consisting of decision structures internal to the institution, as well as decision-structures that sit in other vertical and horizontal governance networks. Outcomes in collective decision-making structures are not contingent upon the decisions made by one or even a few

specific actors but on groups of actors who are required to make group or 'consensus' decisions.

This study argues that these three institutionalised characteristics of international financial standard-setting act as the causal mechanisms that can either lead to captured outcomes, or that prevent outcomes from becoming captured. This study proposes that regulators will attempt to use these institutional mechanisms in order to either support their high demand for private capabilities in order to generate favourable outcomes, or constrain private influence when their demand is low, in order to generate outcomes that enhance the authority of regulators. It is further argued that these institutional mechanisms are used as the primary 'substitute' for the legislative authority with which regulators are deemed within their respective domestic jurisdictions, and consequently lack in the transnational governance arenas. As a result, institutional control over norms, processes and decision making allows regulators to exercise some degree of authority over their supply and demand relationships.

Norms. The first institutional characteristic which allows regulators to exercise some control over outcomes is that the creation of international financial standards is about the creation of norms, or how states *should regulate* their financial institutions and how financial institutions *should behave* in accordance with those principles. International financial standards in other words are not something that is neutral or technical but is "laden with power relations, social exclusion and ideology" (Holtzscheiter 2005: 734). The creation of international standards is a less overt power play between actors because as Holtzscheiter argues "the construction of common

knowledge or the creation of commonly agreed definitions and perspectives – these are the dimensions of international politics upon which the notion of global governance heavily relies” (2005: 735).

International policy-making through the construction of standards is not without conflict. Instead, international policy-making such as standard-setting is what Jachtenfuchs argues to be a ‘frame competition’, which is “the struggle between different problem definition, the latter being the basis for the emergence of interests and preferences” (1996: 29). In political systems, this struggle is characterised as a struggle for power, “the power to define a situation authoritatively for all participants in the system and thus pre-structure the way interests can be articulated, claims be made and policy decisions be taken” (Jachtenfuchs 1996: 29). For this reason, actors will attempt to change frames as part of their strategy to pursue their political goals or in addition to this they will also try to promote a certain frame which serves their interests well (Jachtenfuchs 1996: 30). International financial standard-setting therefore is an arena where both regulators and private actors will attempt to frame standards in order to exert their authority.

How do certain frames win over competing ones? It is through discursive means of what Risse (2000) calls the logic of ‘argumentation’. In line with a rational choice or instrumental paradigm, Risse (2000) argues that instrumentally rational actors who are interested in realising their values and interests must be interested in ‘getting the facts right’ and correcting what they see as false information in order to pursue and contribute to ‘common knowledge’. Specifically, even rational actors know that they need to have a common understanding on what it is that they are actually

bargaining about. The logic of argumentation is therefore one that is based on actors who seek to adjudicate normative frames through the process of arguing. It is where actors not only try and challenge the validity of claims made in causal or normative statements but where they also seek a communicative consensus about their understanding of a situation as well as provide justifications for the principles and norms guiding their action (Risse 2000: 7). This logic above all relies on the perception that the frames in which actors communicate have some validity in its intention of creating common knowledge as opposed to 'cheap talk' or rhetoric (Risse 2000: 8). The ability of actors to use language and communication towards creating and constructing common knowledge is therefore one of the ways in which actors can affect outcomes and the more successful they are at providing a legitimate contribution to the policy framing problem, the more successful they will ultimately be at influencing the end outcomes.

The normative nature of the standards-setting task means that the power to frame those standards so that they can pre-structure the way in which interests are articulated rests on technical expertise and discursive capabilities. The successful use of expertise is closely tied to the perception of discursive legitimacy; that is, the more the language used in framing a problem is considered 'objective' (less partisan) in the eyes of other participants and decision makers, the more powerful or influential it becomes in creating policy consensus. However, expertise is also considered just as dangerous if actors are seen to lose their discursive legitimacy in the eyes of others, and thus lose their discursive credibility (Fuchs 2005: 794). Thus, the consequences of private expertise will depend on how private actors

participate in the process of argumentative consensus (that is, in the creation of 'objective knowledge') and the extent to which regulators perceive this to be legitimate thereby contributing to consensus.

Process. The second institutional characteristic that regulators utilise in order to enhance, constrain or reconstruct private technical expertise is through policy processes. International financial-standard-setting is a policy-making exercise, where "each element to policy-making is considered to cause a particular output and outcome" (John 1998: 2). The policy making process may be seen to be a rational exercise where faced with a given problem, actors will evaluate the best possible alternative among choices and make a decision accordingly. However, this understanding does not take into account the way in which actors and the actual process itself can cause particular outputs and outcomes, involving processes of generating ideas about policy options and alternatives, incorporating or not incorporating those ideas into the policy paradigm and then framing or shaping those ideas through path-dependent policy adaptation.

The process of sourcing, generating, and putting forward ideas about policy alternatives is a crucial component of the 'framing' process. However, the framing process also to a large extent involves the process of 'refinement' which Lindblom (1968) refers to as policy 'incrementalism'. Ideas are said to go through a 'pushing and shoving' process of incremental policy adaptation toward the desired ends of those within the policy making stages. A process of 'incrementalism' is defined as a process of mutual adjustment among a multiplicity of actors having different self-interests. Mutual adjustment among a multiplicity of decision-making actors with varying preferences and

values means that policies and policy changes occur through a succession of incremental changes or through a “sequence of approximations” where a process of feedback, consultations (or ‘deliberation’) and adjustments will lead to minor policy amendments (Lindblom 1958, Hayes 1992: 13). The sequence of approximations means that policies are “tried, altered, tried in its altered form, altered again and so on” (Lindblom 1958: 301) giving rise to further demand for modification or expansion and triggering a continuum of a new policy process (Hayes 1992: 13). As a consequence, the way in which policies can emerge is not necessarily from a direct process of calculated choice among strategic alternatives, but rather adjustments that lead to a further sequence of approximations.

The power to influence outcomes therefore is perhaps most effective during the policy framing stage, where actors can play a significant role in influencing adjustments through the deliberation and consultation mechanisms. Haas (1992: 2) argues that private ‘epistemic’³² or policy communities play a crucial role in framing ways to think about certain problems, by articulating for decision-makers the cause and effect relationships of complex problems, helping actors to identify their interests as a result as well as framing issues for collective debate and identifying issues for negotiation. These professionals who tend to be viewed as ‘technicians’ have important discursive capabilities and are seen as an important determinant of international policy coordination as the diffusion of new ideas and information can lead to new patterns of behaviour (Haas 1992: 4).

³² Epistemic communities are defined as “a network of professionals with recognised expertise in a particular domain and an authoritative claim to policy-relevant knowledge within that domain or issue area.” (Haas 1992: 2)

However, at the same time, Lindblom argues that the advantage of the process of deliberation or incrementalism is that it can also offer “the best chance of introducing into the political system those changes and those change-producing intermediate changes that a discontented citizen might desire” (1979: 520). To transpose this to the international standards arena, this means that actors with access to the policy-making process can also influence the normative outcome of decisions. Actors can include not only decision makers, but also support staff (such as Secretariats) and other bureaucrats with access to the policy process. The consequence of the policy making process with its ‘successive adjustments’ through multiple rounds of feedback, consultation, adjustment, further feedback, further adjustment, and so on is that policy can be attributable to either ‘public’ or ‘private’ sources. Policy-making is not therefore “a kind of machine into which are fed the exogenous wishes, preferences or needs of those for whom the machine is designed and out of which come policy decisions to meet these wishes, preferences or needs”; it is instead argued to be a machine that can manufacture policies as well as ‘reconstruct preferences’ (Lindblom 1968: Chapter 12) [emphasis added].

Furthermore, the policy machine does not simply make policy once and for all but “is made and re-made endlessly. Policy-making is a process of successive approximation to some desired objective in which what is desired itself continues to change under reconsideration.” (Lindblom 1959: 86) This means that there is never a fixed end point or policy outcome – there is only a succession of outcomes which are continually being revised and updated based on a “past sequence of policy steps” which have given decision makers

“knowledge about the probable consequences of further similar steps” (Lindblom 1959: 86). It is difficult to determine therefore when an outcome reaches its desired goal, as it can always be amended to incorporate additional policies.

Institutions can also, according to Barnett and Finnermore (2004), develop their own ‘pathologies’; that is, once created, they develop a personae and life of their own, diverging from the initial goals and mandates given to them when originally established. As Barnett and Finnermore argue, “organisations frequently develop distinctive internal cultures that can promote dysfunctional behaviour, behaviour that we call ‘pathological’. We define pathological behaviour as behaviour generated by the internal organisational culture that violates the self-understood core goals of the organisation. Dysfunctions of this type flow from constitutive features of bureaucracy as a social form” (2004: 38).

The bureaucratic form, with its operating procedures and routines as well as their compartmentalised ‘division of labour’, is said to have important consequences for the way in which individuals internal to the organisation can also affect the nature of policy process outcomes (Barnett and Finnermore 2004). Institutions can develop divisions and subunits that generate “their own cognitive frameworks that are consistent with but still distinct from those of the larger organisation, further complicating this process” (Barnett and Finnermore 2004: 38-9). The result is that even though some regulators for instance may wish to enhance the interests of private actors, ‘breakaway’ sub-units within the institution with their own

cognitive preferences may develop policies which run counter to those that support captured outcomes.

Decision structure. The third institutional characteristic that can be used as a substitute for formal authority is the collective decision-making arena. The most dominant collective decision structure that has come to be institutionalised in many collective organisations is the bureaucracy, which is characterised by a high degree of specialisation, hierarchical authority structure, impersonality of relationships between organisation members and the recruitment of officials based on ability and technical knowledge and not political affiliation (Mouzelis 1975: 39). The way in which actors are able to interact and carry out their particular tasks within a bureaucracy depends on how it organises what is essentially a 'division of labour'.

In complex organisations, this division of labour is what Hall (1991) describes as both 'horizontal' and 'vertical' differentiation. Horizontal differentiation simply refers to the ways in which the tasks performed by the organisation are subdivided. Clearly, the more tasks that an organisation is required to do, the more complex the horizontal structure becomes. Various specialists may be required for tasks requiring different skills. Vertical or more aptly hierarchical differentiation is essentially the levels or layers in which horizontal specialists need to go through until final 'decisions' are made. As Hall (1991) argues, authority is distributed in accordance with the level in the hierarchy and the more and the higher the levels, the greater the authority in 'decision' weight.

The ways in which decisions are made depend on the way in which decision hierarchies operate. In international institutions, decision-making

more often than not takes place within *collective* structures, where the power to make decisions is not confined to individuals but rather to committees (Vandenbussche 2006). The 'committee structure' in so many words reduces the vertical hierarchy of decision-making by merging a number of decision-makers (who are more than likely from around the world) to within the same setting. Unlike those within a complex organisation who undertake the more 'horizontal' or specialist tasks of researching options, drafting technical policy solutions, and shaping these into policy outputs for wider and hierarchical consultation, committee decision-makers are there to set agendas and make final decisions by providing broad approvals and endorsements of certain policy options.

Amalgamating several decision makers into one committee however means that decision outcomes will depend on the size, composition and the decision rules of that committee (such as whether decisions are made by majority rule or by consensus) (Vandenbussche 2006). In international institutions where the 'decision rule' is through simple vote, frames or norms are said to win over competing ones due to 'majority' rule. However, where the decision rule is based on consensus agreement, it can be argued that argumentative processes are much more important because agreement has yet to be reached (Jachenfuchs 1996: 29). Thus, within a consensus based decision making committee, 'frame competition' not only occurs along the 'horizontal' policy making path but also then takes place between decision makers themselves.

The decision rule of consensus therefore means that there will be power struggles within decision making committees because outcomes can be

contingent upon which decision makers are able to form or push through their preferred norms. In international forums, this means that consensus decision making is ultimately political, where the most dominant political actors use their material and structural power to convince and cajole their counterparts to ensure their domestic political interests are served. This is why private lobbying is considered such an important part of the arsenal of instrumental capabilities as simply having the means to be present at decision-making meetings and roundtables is significant because it gives private actors the ability to engage in what Lindblom (1968) refers to as a crucial but also very 'grey' area of decision-making, which is the universally understood but analytically sidelined process of the informal wheeling and dealing behind the scenes. Such informal interplay through more subtle forms of persuasion and the personal 'airing' of views between actors is an important supplement to the more formally organised methods of policy cooperation (Lindblom 1968).

Complex committee decision structures means that the exercise of power within these structures can occur at various 'levels' or layers within the organisation and hierarchy. It also means that these collective decision structures may constrain the effective exercise of private power because influencing numerous decision-makers who need to reach consensus is logistically more difficult. Furthermore political actors all vying for a piece of a consensus decision can also use their power to block or obstruct private influence if those actors are seen to be a threat to the political preferences of actors. Blocking or obstructing private influence can simply be the act of excluding or removing private actors from the committee decision process or

by opposing member decisions which reflect those private preferences and thereby disabling the ability of the committee to come to a consensus. Political 'wheeling and dealing' therefore become more important in consensus environments as the need to reach a meeting of the minds becomes more critical than serving sectional private interests. This then creates a complex setting of a myriad of different 'micro' organisations each with their own power structures and simultaneously residing within the wider 'macro' organisation.

It is argued in this study that these three characteristics, norm creation, policy process and collective decision structures are the key features through which both public and private actors carry out their supply and demand relationship. This means that preferences, if they get through the institutional maze, can be shaped, moulded or more significantly *reconstructed* within the 'pathologies' of institutions to produce varying outcomes. Using these three institutional characteristics, the following sections outline how regulators facilitate and constrain the production of captured outcomes, based on their varying demand for private capabilities.

The mechanisms for facilitating and constraining capture: a framework for empirical analysis

Earlier in this chapter, it was proposed that regulators and private actors engage in what is described as a supply and demand relationship, where private actors supply various instrumental capabilities because it enhances their leverage for obtaining favourable policy outcomes. Public regulators and policymakers also use these sources of instrumental power to enhance their own political standing or professional security. Such a relationship can

therefore create a 'win-win' for both sides. Furthermore, this study also proposed that capture does not occur simply because there is a supply and demand relationship between regulators and private industry, but when demand for a specific private capability is high; that is, when regulators are unable to fulfil their regulatory roles and policy requirements without the input of private power capabilities. The proposition that regulatory demand could also fall was also put forward, based on when the capability has fulfilled the regulator's initial purpose, or when regulators perceive private power to be a threat to their authority.

The study has also argued that whilst this explains the reasons for why regulators and private actors engage in this sort of exchange dynamic, it does not provide the causal mechanisms for how this dynamic produces outcomes which are captured or not. As such, the study also proposes that regulators will attempt to use institutional mechanisms, by way of adopting certain institutional practices, to either enhance the supply of private capabilities thereby leading to captured outcomes, or alternatively constrain the supply of private capabilities, thereby reducing the likelihood of outcomes becoming captured. This has been illustrated in Figure 3.1 and Table 3.2 where varying regulatory demand will lead to different institutional practices.

Figure 3.1 Matrix of Influence

		High Demand			
Low Threat	High demand/low threat Capture	High demand/high threat Institutional Constraints			
	Low demand/low threat Status quo	Low demand/high threat Institutional control			
		Low Demand			
				High Threat	

As seen in Figure 3.1, there are four main scenarios of influence based on the varying level of demand and level of perceived threat to regulatory authority. The first scenario of capture is based on a high demand for private capabilities and where the use of private capabilities is perceived by regulators to enhance their authority (or a 'low threat' from private actors). In this scenario, institutional practices will be used to facilitate the adoption of private preferential norms into standards outcomes. The second scenario is based on the status quo, where no change or action is prompted based on a low level of demand from regulators and a low corresponding threat from private actors. The third scenario however is one that is based on a high demand for private power capabilities but a correspondingly high threat from the same sources of power. A high threat means that regulators will perceive private capabilities to undermine their political and or policy making

authority. In this scenario, regulatory action will be geared towards using institutional practices to include private actor when the source of power is needed, but also simultaneously exclude private actors so that regulators maintain their decision making authority over outcomes. The fourth scenario is where demand for private power capabilities falls and the corresponding threat to regulatory authority is perceived as high. In this instance, regulators will utilise institutional mechanisms to ensure they can ultimately control the process and outcome of decisions.

These scenarios warrant a discussion on just what and how these institutional practices work to produce these varying outcomes. The following table 3.2 provides an illustration of the institutional practices that can be utilised in order to facilitate capture, to put in place institutional constraints, and also to ensure institutional control over outcomes. These practices or mechanisms are based on the three main institutional characteristics of international standard-setting forums, namely institutionally generated norms, processes and decision structures. It is proposed that these practices are used instrumentally by regulators in order to enhance their interests and importantly, their political and or policy making authority.

Table 3.2 Institutional practices to enhance regulatory demand

	High demand/low threat ↓ Capture ↓	High demand/high threat ↓ Institutional Constraints ↓	Low demand/high threat ↓ Institutional Control ↓
Tools ↓			
Norms	Norms sourced from private actors, drafted by private actors	Norms sourced from private actors, drafted by regulators	Norms sourced from and drafted by regulators
	Private norms introduced and adopted	Private norms reconstructed to include vested regulatory interests	Private norms rejected or existing private norms deleted
	Norms developed to allow private self-regulation	Norms developed to give regulators supervisory power	Norms developed to give regulators legislative power
Process	Deliberation with private actors undertaken throughout policy development	Limited deliberation with private actors undertaken in later stages of policy development	Deliberation with private actors not undertaken
	Frequency of meetings with regulators increased	Frequency of meetings with regulators reduced	Access to meetings with regulators denied or other stakeholders included
	Comments from private industry adopted and standards changed	Comments from private industry partially adopted and standards partially amended	Comments from private industry not adopted, no changes to standards
Decision Structure	Private decision making authority	Private decision making authority changed to regulatory decision making authority	No private decision making authority
	Decision making authority at Board, sub-committee and sub-group levels	Decision making authority at Board and sub-committee decision levels	Decision making authority at Board level only
	Private participation in committee structure	Private participation in committee structure limited or structured	No private participation in committee structure

Based on the types of institutionally generated practices outlined in Table 3.2, we can begin to construct a framework for an empirical analysis of how supply and demand relationships can produce outcomes which are captured, or alternatively, how captured outcomes may become constrained by the ways in which regulators will resort to the institutional infrastructure to enhance their leverage over private actors. Firstly, we can begin to understand how outcomes are able to become captured, through the ways in which institutional norms, processes and decision structures can be intentionally shaped by agents so that these features can support policy outputs which favour the optimal supply and demand cycle of private capabilities and therefore enhanced regulatory policy authority. However we can also start to deconstruct where, in the institutional framework, regulators can begin to manipulate policy inputs to the extent that outcomes can be fundamentally reconstructed in order to place the onus of authority and control back in the hands of regulators.

This matrix of influence therefore contemplates that outcomes are not always 'captured' as a result of a close relationship between regulators and private actors, but instead there is a spectrum of outcomes which can ensue from the supply and demand dynamic between regulators and private actors. It also contemplates the proposition that regulators are not simply 'vessels' through which private power passes through, but are in fact important causal forces shaping how capture is produced and facilitated. This means that regulators can facilitate private power over norms, process and decision structure where each of these elements is crucially linked in their causality:

that is, private actors and their respective capabilities must 'get through' these stages in order for an outcome to be captured.

High demand, low threat - enhancing capture: the ability to shape the underlying normative framework of standards is the first way in which private capabilities can be used and lead to captured outcomes. Shaping the underlying normative framework of standards through the provision of resources either by way of technical expertise, data or more generally information means that the ultimate benefits flow to those who create the norms. Regulators facilitate and enhance private norms when such resources are *sourced* from private actors or if standards are *drafted* by private actors. Evidence of standards that are sourced from or drafted by private actors would include the identification of private actors within the 'horizontal' task areas within standards organisations (such as within working groups or committees), or policy proposals drafted by private actors external to a standards organisation which are then adopted by policy makers.

Private capture may also be evident if regulators are convinced of the merits put forward or practised by private industry, thereby adopting similar practices in regulatory standards. This can otherwise be referred to as the norm of 'self-regulation' where the onus is placed on industry to monitor and evaluate the riskiness of their activities. This means that regulators are not only 'sympathetic' to the approaches proposed by private industry, but they also adopt the ideas proposed by private actors, including their rationale, discourse and methodology for those ideas within their standards content. The result is that standards have adopted underlying market ideologies or

methodologies that are based on market norms and thus more likely to reflect the preferences of private actors.

In addition to this however, capture would be evident if these norms are maintained throughout the process of deliberation and policy ‘incrementalism’. A key condition that would lead to captured outcomes is if standards that have been shaped by private actors are not changed by regulators during the consultation and deliberation mechanisms to reflect other views. This means that deliberation, consultation and views obtained from the wider public do not impact the market-sourced standards content and deliberation undertaken by regulators is simply a formality. Evidence of this condition would show that what was initially drafted by private actors or sourced from private actors does not change over the process of deliberation.

Capturing the policy process is also evident if standards, which were not initially shaped by market norms, are amended by regulators to reflect private views obtained from policy deliberation. Standards that do not reflect private preferences have the potential to become captured when changes that are made to a standard are only made because private actors have advocated the change in consultative forums. Evidence of this includes any substantial changes from initial drafting, ultimately reflecting the views and preferences of private industry.

Capture can also be established if there is decision power over standards outcomes. Decisions at this stage will have already been shaped through establishing market norms in standards content and decision-making is simply the formal seal of approval. Capture over final outcomes indicates that there are limited or no argumentative processes within

collective decision structures because regulatory decision-makers have formed consensus agreement based on this premise. In addition to this, capture over decision outcomes may also be evident if standards outcomes are the result of private actors exercising decision authority, or where private actors participate directly in policy groups which exercise decision authority. For instance, where there is private participation in groups with decision authority, captured decision outcomes for standards may also be greater where decision authority is given to a number of different 'vertical' decision levels (sub-groups, working groups etc) as opposed to restricting all decisions to the Board or 'apex' level of decision making.

Therefore, it is proposed that when regulatory demand for private capabilities is high, the institutional infrastructure would also support private capture over norms, processes and decision structures so that outcomes reflect private market preferences. However, when demand falls, or simultaneously when the perceived threat from private actors increases, capture is not likely to occur when institutional norms, processes and decision structures are used to constrain private preferences.

High demand, high threat - constraining capture: regulators may be in situations when their high demand for private capabilities corresponds or is followed by a perceived threat to their policy-making authority. When this occurs, regulators can resort to the institutional infrastructure and attempt to curb the full extent that private actors may capture outcomes. For instance, regulators threatened by the technical authority of private actors may not be in a position to establish their own discourse to counter private norms, but they are empowered through institutional means to reconstruct private

discourse and tailor it to suit their own purposes so that the perception of their authority is enhanced. Private actors supply their discursive capabilities to regulators, but what regulators choose to do with this capability will depend on how it is seen to enhance their authority. When it is seen to be detrimental, regulators can resort to using the 'policy machine' to reconstruct or fundamentally pare back the market-based discourse. Various amendments to existing discourse could also be made, reconfiguring initial market methodologies and norms to include vested regulatory interests, and thereby changing its intended utility designed to enhance private industry activities.

Regulators can also constrain capture through the policy process, by introducing "intermediate changes that a discontented citizen might desire" (Lindblom 1979: 520). Regulators in decision-making capacities may choose to delay, change or even remove certain market-based norms at the various stages and levels of decision-making. Regulators may also resort to changing the nature of interaction or even frequency of deliberation with private actors. This means that the participation of and interaction with industry could also be closed off or opened only at the very last stages of deliberation and undertaken simply as a formality. The end result of this is that rather than being seen to be dependent on vested interests, regulators can use existing discourse to serve dual purposes: firstly, to serve the supply-side of the relationship, where regulators adopt elements of private discourse and be seen to be in touch with 'market realities'; and secondly, to justify their own positions of authority, by including elements that are compatible with their domestic regulatory mandates and to fulfil their wider public function.

The decision structure may also be changed to restrict private actors from either participating in policy groups or making decisions at any of the decision levels. The restrictions on private actors participating in sub-group levels may also correspond with changing decision making authority from sub-group levels to Committee or Board levels. These institutionalised rituals of changing participation or decision rules is not primarily to ensure that regulators are empowered to make decisions; instead, they act as more overt actions to signal that private actors are encroaching on regulatory policy authority and in conjunction with using norms and processes, is designed to simultaneously foster private supply of capabilities as well as emphasise the ability of regulators to change outcomes if need be.

Low demand, high threat – controlling outcomes: this last scenario arises from a substantial drop in demand for private capabilities and correspondingly high level of perceived threat to regulatory policy authority. This situation would indicate that there has been an extraordinary shock or event that has undermined the position of regulators and as a result has forced them to use their institutional environment to bolster their power. Private capabilities as a result are correlated with this threat to regulatory authority and as such, regulators resort to sourcing information from other regulators and standards are then also drafted by regulators. There is no attempt to incorporate private norms, and existing private norms are also removed from standards. The most fundamental way in which regulators seek to control standards outcomes and indirectly, over private actors is to seek legislative power to enact their policy and decision authority.

In this scenario, policy deliberation with private actors is either restricted or not undertaken and access to meetings with regulators is also denied. Meetings, if conducted, are a formality and conducted in open and formal settings where a number of other different stakeholders also attend. Comments from open deliberation do not have any effect on standards content, and regulators go ahead with proposed changes despite the potential for the changes to have a negative impact on private actors. Participation in policy groups is also denied and decision authority is also centralised at the apex or Board level of authority. Overall, regulatory seek to use the institutional infrastructure to fundamentally control outcomes so that they enhance the perceived authority of regulators.

Based therefore on the scenarios outlined in the matrix, there are four potential findings that we may be able to conclude from an empirical analysis. The first potential finding is that there is evidence of captured outcomes, meaning that the demand for private capabilities is high and that the supply of private capabilities enhances the perceived authority of public regulators. Furthermore, this captured relationship is then able to thrive within institutional boundaries meaning that market norms survive the formation, process and decision stages in the comparative standardisation cases. The captured relationship has been able to sufficiently ensure that outcomes are favourable to private preferences and interests, representing a 'classic' case of regulatory capture. We can surmise that if this is the case, then the power capabilities of private actors provided to public actors would have contributed to the establishment of institutional settings that were also

geared towards private preferences making it easier for private preferences to 'get through' the process and structure of institutionalised deliberation.

The second potential finding is that there is no or low demand for private power capabilities or where there is demand, private industry has not been able to provide this capability sufficiently. This would include instances where regulators have sought power capabilities from private industry and rejected them, or private actors have not been in the position to provide the specific capability. Furthermore, where there is weak or insufficient supply of capabilities, private actors have not been able to exert power over institutional boundaries, meaning that they are not able to influence the underlying normative frameworks, have not been able to affect changes during policy deliberation and have not been able to exert pressure or power over decision makers to get outcomes reversed or amended. Either way, a willing demand and supply of private power cannot be established and the outcome would result in the status quo being maintained or put simply, no capture. These findings would evidently refute the thesis of private capture but would nonetheless generate some interesting insights into not only why there were barriers to the capture of the public-private relationship but also why institutional boundaries acted in such a prohibitive way.

The third potential finding is where demand for private power capabilities is high, and the use of such capabilities also poses a high perceived threat to the authority of regulators. This would indicate that whilst private power has been able to fulfil an initial purpose, it has in the process veered from its initial utility and prompted regulators to impose institutional constraints. This means that there could be instances of initial capture, and

outcomes that ultimately are not captured by private interests. For instance during the initial formation and deliberation processes, standards have been shaped to include discourse and norms from private sources but have been altered or amended during the policy process. Alternatively decision makers decide at various stages of the process to include other elements into the standards that are not aligned with market preferences. This potential finding is what we can only refer to as an embedded outcome, where governance results from the integration of public and private norms.

The fourth potential finding is where demand for private power is low, and correspondingly private power is perceived to be a serious threat to the authority of regulators. In this instance, regulators may resort to curbing private power altogether, by using institutional mechanisms to ensure that private actors are excluded from any form of deliberation, and that regulators are empowered to control the activities of private actors in a 'top-down' manner. This form of governance could be characterised as 'dirigisme', where the power to decide ultimately resides with regulators. This potential finding would indicate that there has been an extraordinary 'shock' or event that has undermined the position of regulators and as a result has forced them to use their institutional environment to bolster their power.

The third and fourth potential findings have important implications for understanding how the *nature* of private influence may differ in accordance with the type of demand, the way in which the power capabilities are supplied and how the institutional mechanisms are used to either enhance or curb private power. The nature of integrated public and private outcomes may therefore be the result of public or private power intervening

at different stages of the governance process, which can be described as either the public integration of private power or the market integration of public authority. For instance, the public integration of private power would indicate that whilst public actors are the policy and decision makers within a standards organisation, private actors play a key role in shaping the normative content of those standards through deliberation. On the other hand, the market integration of public authority would indicate that whilst private actors act in policy and decision making capacities, public actors also then play a critical role in shaping the underlying normative frameworks of market standards to include public priorities and normative considerations.

This means that there is a dual functionality to the understanding of private power in governance, which does not necessarily entail the preponderance of private market interests. What it does potentially show is that the relationship between public and private actors is a constitutive one; that is, neither public nor private actors can undertake governance without the other and their actions are reinforced and constituted by the actions of the other. Private capture may simply be a case of private power prevailing over outcomes. However, the more interesting possibility is that 'capture' is a much more embedded and integrative governance relationship between public and private actors. Important for this analysis is the way in which institutional boundaries of interaction may determine the integrative and constitutive nature of the public-private relationship, which can then yield important insights into how institutions can frame a balance in the exercise of both public and private power.

3.3 Conclusion

There is no denying that private actors exercise influence in international policy arenas, and an important question that this study seeks to address is how influence leads to capture, particularly at the translational level of financial governance. What this chapter has canvassed is that private influence is part of a supply and demand relationship between regulators and private actors that has been institutionally reinforced and engrained. The relationship thrives when there is a high demand from regulators and a willing supply from private industry, creating conditions for the mutual benefit of both parties. This relationship leads to capture if it is reinforced through the institutionalised norms, processes and decision structures that support and enhance the supply and demand cycle of interaction. This study proposes that the mechanisms that lead to capture therefore are institutional mechanisms, which are determined on the basis of whether private power capabilities fulfil the demands of public regulators and enhance their authority, thereby leading to regulators producing standards which reflect this mutually beneficial 'win-win'.

However, the framework also provides for the scenario when demand for private capabilities falls, because the utility of the capability wanes or these capabilities threaten the authority of regulators. Under these conditions, regulators are likely to resort to the 'policy machine' in order to curb the influence of private actors and enhance their own authority. When assessed in this manner, institutions are an important variable in understanding the way in which private influence operates. An institutional analysis of supply and demand power relationship helps to identify the causal

links from the 'close' relationship between public and private actors and subsequent policy outcomes through an analysis of the underlying formation of norms, policy processes and decision structures. Policy outcomes are therefore contingent on the institutional conditions that govern the working relationships between policymakers, private market actors and their 'transaction costs'.

4

The Basel II Capital Framework and the ‘creeping conservatism’ of the Basel Committee on Banking Supervision

The Basel Committee for Banking Supervision (BCBS³³) has become one of the central organs of global economic governance, acting not only as a locus for financial decision-making but also as a key facilitator for coordinating the actions of other international financial institutions (Wood 2005). The BCBS standards are so influential that they have in effect become the blueprint for the regulation and supervision of international banking, governing a range of supervisory issues for regulators around the world³⁴. However, such a level of influence over the governance of international banking raises serious questions about the nature of the BCBS’s power and the implications of this power for wider public interest imperatives. More importantly for this study is the assessment of how this standards regime is influenced by private industry.

Adopting the theoretical framework advanced by this study, this chapter argues that in the case of the BCBS, there has been a high demand by regulators for private information and technical resources. The regulators of the BCBS have demanded and sought the expertise of private industry in order to access information that they would otherwise not have been able to attain. In return the largely American (US) and European (EU) international

³³ Also referred to as ‘the Committee’

³⁴ The BCBS has itself stated that its Core Principles for Effective Banking Supervision have become a “comprehensive blueprint for an effective supervisory system.” See the History of the BCBS at <http://www.bis.org/bcbs/history.pdf>

banks have willingly supplied this information to try and influence the decisions and standards content produced by the BCBS. The example used to show this is the case of the Basel II Capital Framework (Basel II). Basel II has been highly influenced by private market norms, due to a high demand for technical alternatives to the outdated methodologies evident in the first Basel Accord (Basel I). The large international banks have been at the forefront of supplying these technical alternatives, by supplying their internal ratings based (IRB) methodologies to regulators. These approaches fulfilled the demand from regulators, initially enhancing their credibility by producing an alternative to Basel I that was seen to be more aligned with market realities.

However, this chapter also finds that as these approaches were gradually developed, some aspects were perceived to undermine the domestic regulatory prerogatives of regulators. As a result, the BCBS has simultaneously reconstructed Basel II to include elements of 'conservatism' that have acted to counter the incentives produced by the internal models approach. It has introduced these elements of conservatism through primarily ad hoc policy proposals and consensus decision processes, where disagreements between members mitigated the full adoption of private norms. As a result, private norms initially adopted by regulators were gradually reconstructed to suit the preferences of largely the EU regulators of the BCBS. Regulatory fragmentation in the US has also enabled the EU to exert power over the BCBS policy process. As a result, this chapter shows that the BCBS has been a case of both capture and constraint, resulting from high demand but a corresponding increase in perceived threat from private industry.

4.1 High demand, low threat: the BCBS, private norms and the capture of Basel II

The BCBS and the supply and demand of information

The BCBS has been a pivotal force, if not the impetus towards the steady proliferation of financial standard setting bodies we see today³⁵. Its influence over both domestic regulatory outcomes and more importantly over the paradigm of banking regulation more generally is unquestionable. It is for these reasons that the issue of private industry influence becomes more pertinent as the Committee's influence continues to grow in financial governance. This is also particularly important given its expanding role going forward in light of the fallout from the global financial crisis³⁶.

A brief examination of the BCBS's history gives us some background as to why the BCBS has had a high demand for information and technical resources. The BCBS was initially established in 1974 by the G10 Central Bank Governors as a Standing Committee of the BIS. Until only recently³⁷, there were 13 members of the Committee, namely Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Spain, Sweden, Switzerland, United Kingdom and United States. These member countries are represented by their central bank and also by the authority with formal responsibility for the prudential supervision of banks. The Committee reports to and seeks endorsement from their respective central bank Governors and

³⁵ The BCBS was one of the first standard setting bodies established and the first Basel Accord (Basel I) was a significant precedent for other international financial standard setting bodies established in other financial issue areas. See for instance Wood (2005), Davies and Green (2008) and Tarullo (2008) for more information on the rise of the BCBS.

³⁶ The G-20 has already mandated that the BCBS deal with the weaknesses revealed by the crisis, by expanding the scope of the Basel Framework to include such measures as a leverage ratio and increased capital requirements. See the G-20 (2008a) and G-20 (2008b)

³⁷ In March 2009, the BCBS announced that it had expanded its traditional G10 membership base to include Australia, Brazil, China, India, Korea, Mexico and Russia. See BCBS (2009a)

to the heads of supervisory authorities of these countries where the central bank does not have formal responsibility. The Committee itself meets only four times a year, but is provided with a full Secretariat by the BIS, which is staffed by 15 professional supervisors on temporary secondment from member institutions.

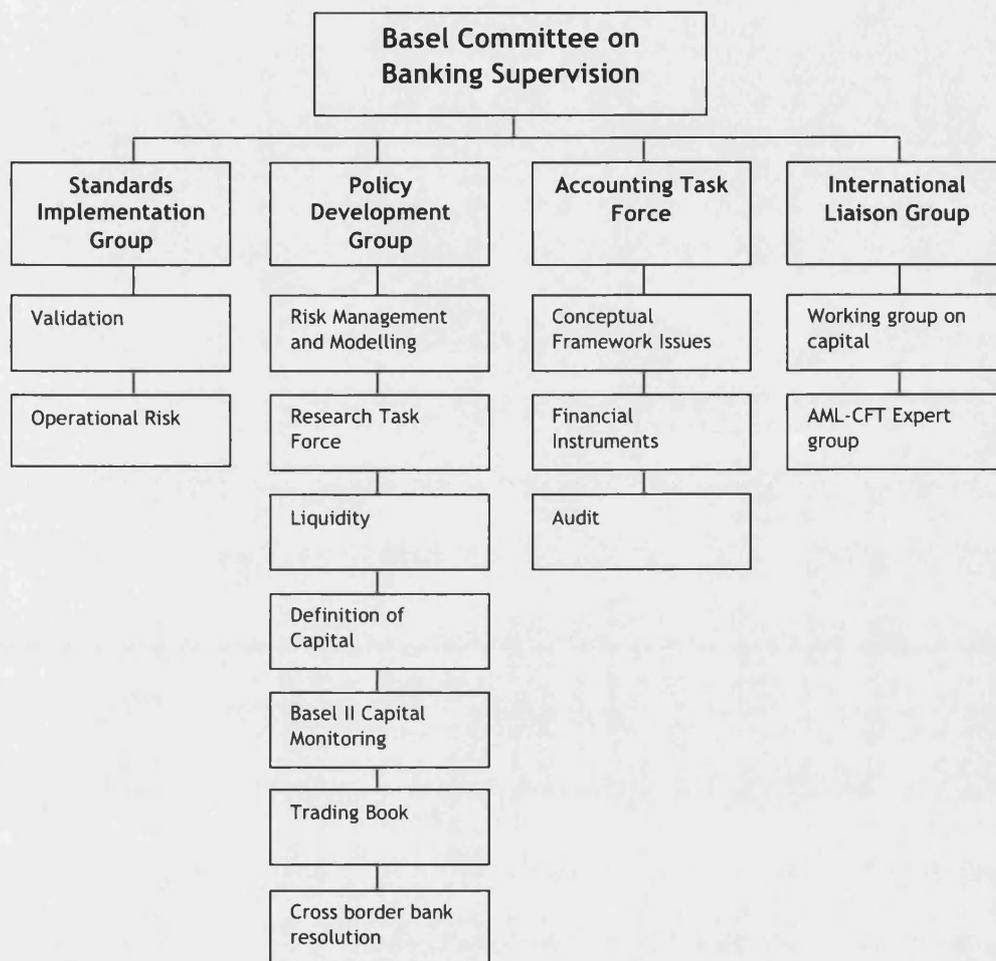
The Committee also has four main sub-committees that meet more frequently³⁸. These sub-committees are responsible for undertaking the standard-setting work on which the Committee makes decisions. There are also 'sub-working groups' within each of these sub-committees that specialise in specific issue areas. Furthermore, within these sub-groups there are also dedicated 'drafting groups' which as the name suggests are responsible for the actual drafting of working papers and ultimately standards. One of the more important sub-committees of the BCBS is undoubtedly the Policy Development Group (PDG), whose primary objective is to support the Committee by identifying and reviewing emerging supervisory issues and, where appropriate, proposing and developing policies that promote a sound banking system and high supervisory standards. The PDG oversees a further seven sub-working groups, which cover dedicated issue areas such as risk management, liquidity, the definition of capital, trading book issues, and cross-border resolution issues. Another main sub-committee is the Standards Implementation Group (SIG) which focuses on implementation of Basel Committee guidance and standards more generally. It oversees a further two

³⁸ See the History of the BCBS at <http://www.bis.org/bcbs/history.pdf>

sub-working groups dealing with validation of systems and operational risk³⁹.

The structure of the BCBC is illustrated in Figure 4.1.

Figure 4.1 BCBS Organisation Chart⁴⁰



The composition and structure of the BCBS therefore highlight four important characteristics. Firstly, the BCBS is represented only by public regulatory authorities who report directly to their political Heads of Supervision, which in most cases are national Finance Ministries. Secondly, the BCBS is evidently a very small group of regulators, most from the most

³⁹ For an overview of the BCBS sub-committees, refer to BCBS website <http://www.bis.org/bcbs/index.htm>

⁴⁰ BCBS chart found at <http://www.bis.org/bcbs/organigram.pdf>

wealthy and powerful economies in the world⁴¹. It is, as Baker (2006) argues, an explicit case of the club model populated originally by G-10 countries who engage in inner circle bargaining, and are accountable only to the respective Heads of Supervision and Finance Ministers. Thirdly, there are only four opportunities a year for the BCBS Committee members to meet and to make key decisions on outcomes placing great significance on these meetings for progressing issues and finalising policy matters. Finally, these meetings are explicitly ‘closed’ which means that only members of the BCBS Committee attend, unlike other standard-setting bodies that allow ‘Observers’ or ‘Guests’ to participate in Board meetings⁴².

Based on these four characteristics, the BCBS has been less sympathetic to the more overt forms of private influence through lobbying and structural ‘sway’ based on market share and size for two main reasons. Firstly, the fact that the BCBS represents many of the most powerful markets in the world means that the majority of member countries have very large global banking conglomerates domiciled in their jurisdictions which, in a global banking market place, have equally significant systemic impact should one of them fail⁴³. Hence, from a systemic and prudential perspective, the structural conglomeration of the world’s major banks across borders and their dominance in the innovation of financial markets make them all

⁴¹ Moreover, Committee members are also said to ensure that there be at least one representative from their own home jurisdictions sit on all of the major sub-committees and, if important enough, on the sub-working groups as well. This is important, considering that most of the sub-committees consist of no more than 20 to 30 members, with some sub-committees populated by more than one member from a single jurisdiction. This was based on confidential interviews with the BCBS undertaken in 2006.

⁴² These bodies include the IAIS which includes private Observers as part of the IAIS membership – see Chapter 5 for details. Another case is the IASB which although is a private body also invites ‘Observers’ and ‘Guests’ to be part of their Board meetings – see Chapter 6 for details.

⁴³ It was also recognised by the BCBS and private industry in confidential interviews undertaken in 2006 that some of the members of the BCBS have more systemic impact over global markets than others.

important due to their systemic importance. Secondly, and more practically, because BCBS meetings are 'closed' to external parties and stakeholders, and these meetings take place only four times a year, the BCBS expects that the more traditional forms of lobbying have already taken place at the domestic level of deliberation. Members are expected to come to the BCBS meetings with their views and preferences based on their domestic regulatory prerogatives already inherently included in their BCBS-level of deliberations⁴⁴.

However, one resource that the BCBS as an institution does depend on and needs from private industry directly is information - in particular, information that has already been sourced from the wider banking community worldwide and 'assembled' ready for BCBS use and consumption. A crucial reason for this need for private industry input is that the BCBS (or the member countries of the Committee) cannot freely obtain this information from other regulators around the world because of domestic privacy laws; that is, they are unable to freely access private industry data on regulated industries unless there are bilateral agreements or domestic laws in place which allow other foreign regulators to access this information. The alternative for the BCBS has been to send out 'surveys' and other data gathering exercises⁴⁵ to foreign regulators which not only take time to distribute but also require significant time and resources to compile and assemble.

⁴⁴ Based on confidential interviews with the BCBS undertaken in 2006.

⁴⁵ In the form of the Quantitative Impact Surveys (QIS). The impact of the QIS exercises will be discussed later in this chapter.

Given the difficulties associated with obtaining information, large private industry groups and large global banks individually have ascertained this demand from the regulators and sought to supply the BCBS with such information directly. Moreover, they have also ascertained this demand as an opportunity to influence outcomes by influencing the normative frameworks upon which regulators would base their understanding - put simply, preferential market discourse. In other words, privately generated information not only offers regulators intimate knowledge of how the industry operates but it also enables banks to put forward information that benefits and favours their normative preferences.

Packaged as 'technical advice', private industry have used their technical resources as a means to not only infiltrate the closed decision making Board meetings but more importantly, the preliminary work undertaken by the Board's four main working groups and sub-groups. Tapping in to this unique opportunity, a number of major national and international banking associations that represent the largest G-10 banking conglomerates⁴⁶ such as the International Institute of Finance (IIF), International Swaps and Derivatives Association (ISDA), London Investment Bankers Association (LIBA), the British Bankers Association (BBA), the Financial Services Roundtable and the European Banking Federation (EBF) to name a few have been pivotal in not only acting as a vital communication link between the major international banks and the BCBS but also in providing the BCBS with readily available 'assembled' information for their use. They are not there to simply lobby the BCBS but rather to act as sources

⁴⁶ The G10 study commissioned on Financial Conglomeration specifies 'G10' conglomerates to include those in the G10 countries plus Australia and Spain. Refer G-10 (2001)

of technical information about the business of their members and the way in which their members operate in the market. Above all, what makes their influence effective is the fact that they are organised in such a way as to ensure that they are promptly responsive to the information needs of the BCBS.

All of these major banking associations (as well as some of the larger individual conglomerate banking groups) have established specific working areas that are dedicated solely to providing information to the work undertaken by the BCBS. Taking the IIF as an example, this global body represents more than 320 of the world's largest commercial banks, investment banks, as well as a growing number of insurance companies and investment management firms. Being a global association, it has explicitly organised and aligned itself to mirror the work of the BCBS Committee and sub-committee structures. Specifically, like the BCBS, the IIF is made up of a Board of Chief Executive Officers (CEOs) and Chairs from the major G-10 banking groups, strategically considered no doubt in order to maximise their influence over nationally affiliated Committee members. It is also organised alongside each strategically important sub-committee and sub-working group so that a dedicated team of specialists in that particular area can have maximum technical input and proximity to the working groups who are responsible for drafting and amending the standards.

For instance, the IIF established its own 'Steering Committee on Regulatory Capital' which has set up its own sub-working groups, such as the 'Working Group on Operational Risk' (WGOR) to deal exclusively with the BCBS's Operational Risk Subgroup (AIGOR) and "engage with the Basel

Committee's Operational Risk Sub Group in regular dialogue on the form and structure of the regulatory capital framework for operational risk at banks”⁴⁷. This sub-structure established by the IIF is designed not only to address the issues at hand in more dedicated detail but also to maximise interaction and contact with the BCBS’s own sub-structure. As one key industry insider revealed, this structure has enabled them to contact key BCBS sub-committee members by phone directly if need be⁴⁸.

The BCBS has also actively sought information and input from private industry in its deliberation and consultation mechanisms, as well as through their Quantitative Impact Studies (QIS) concerning primarily the impact of the Basel II proposals on banks. As will be further elaborated, the QIS exercises to collect data played a pivotal role in prompting the BCBS to adjust key areas of Basel II that increased capital as opposed to the intended aim of providing incentives for banks by way of a capital reduction. The BCBS has also used private industry (and particularly the major banking associations) as regular sounding boards for pipeline proposals. As one source revealed, major banking associations were a convenient way for the BCBS to obtain a lot of views from the one place⁴⁹.

As a result of the BCBS composition, closed meetings and “opaque decision making process” (Alexander 2009), private industry has had more opportunity to use their discursive capabilities through the provision of information to the BCBS, as opposed to more overt forms of lobbying. There is no denying that the latter also exists, particularly at the domestic level of

⁴⁷ Refer to the IIF website for further details <http://www.iif.com/regulatory/basel/>

⁴⁸ Based on confidential interviews conducted in 2006.

⁴⁹ This comment was made by a BCBS official in interviews undertaken in 2006

regulatory politics, but the important point to emphasise is that the BCBS has openly sought private information resources directly through the deliberation and consultation mechanisms. Furthermore, this discourse has been assembled in a way which is easily consumable by the regulators and above all, seen to be 'technically objective' as opposed to pushing a vested agenda⁵⁰. Given this opportunity for influence, one of the most important standards produced by the BCBS has been significantly influenced by private industry as a result of their discursive input.

The BCBS's high demand for private industry's technical resources was for instance exemplified by Basel II. One of the most significant standard-setting areas of the BCBS has been the Basel Capital Framework which are standards governing the level and quality of bank capital. The first Basel Accord established in 1988 or in short 'Basel I' was a highly contested and controversial issue area, namely because of its attempt to apply what has been referred to as a 'one-size fits all' approach to bank capital which over time proved to be increasingly ill-suited to the differences that existed in the portfolios and businesses of internationally active banks⁵¹. As a consequence, during the 1990s the BCBS was increasingly called upon by the international banking community as well as regulators to provide qualifications on aspects of the Accord in order to improve its applicability and efficacy for international banks. Furthermore financial innovations were beginning to outpace the static and largely crude 'risk bucket' approach of the original Accord, calling into question its intended utility⁵².

⁵⁰ This comment was made by a BCBS official in interviews undertaken in 2006

⁵¹ For an overview of the main criticism of Basel I, see Tarullo (2008)

⁵² The original Basel I framework incorporated a number of 'risk buckets' within which certain assets were placed and a corresponding capital requirement assigned. As Tarullo explains, the simplicity of

However, it was the political impact of the emerging market financial crises of the 1990s⁵³ that placed significant pressure on the BCBS to come up with alternative approaches to deal with increasing complexities evident in rapidly globalised financial markets. The impetus towards creating a new Accord was in the words of the Committee due to the “the risks that internationally active banks from G-10 countries have had to deal with have become more complex and challenging”, highlighted by the economic turbulence arising from the financial crises in the emerging market economies during the 1990s (BCBS 1999:4). The Committee was therefore in a position where it needed to not only revise a standard but also develop new or more updated methodologies for calculating and providing for regulatory capital at a time where the world’s financial systems were looking for ways to address the financial innovations that were seen to be destabilising the global economy (BCBS 1999)⁵⁴. The escalating need to qualify the Accord culminated in the BCBS’s decision to undergo a complete revision of the original Basel I and in 1999 the BCBS issued its proposal to establish a new capital adequacy framework, referred in short as ‘Basel II’.

The BCBS therefore had a high demand for discursive and technical input that would solve the BCBS’s dilemma as to how to address capital for

this approach meant that assets with very different ‘economic’ risks were being assigned the same risk weight. This raised concerns that because the risk weighting could potentially diverge substantially from the actual risks entailed by certain assets that the resulting minimum capital levels would be insufficient to achieve the desired level of safety and soundness. See Tarullo (2008) pages 79-80

⁵³ Emerging market financial crises began in Mexico in 1994, and culminated in the East Asian crisis of 1997-1998. The IMF argues that unhedged currency and interest rate exposures played a central role in the Mexican and East Asian crises. Refer IMF (1998)

⁵⁴ The political significance of international standards without doubt escalated after the emerging market crises of the 1990s when the IMF and World Bank incorporated international standards as ‘best practice’ into its plans to ‘strengthen the international financial system and to better manage the risks associated with globalisation’. Refer Report of the Managing Director to the International Monetary and Financial Committee on Progress in Strengthening the Architecture of the International Financial System and Reform of the IMF, 19 September 2000

complex financial innovations that were being developed in the market. Regulators, particularly in the US, had become increasingly aware that financial innovations and rapid technological developments advancing sophisticated risk modelling techniques had become prevalent amongst the large US banks. The earliest and most indicative precursor to Basel II was the amendment made to incorporate market risk into Basel I.

In 1993, the BCBS had issued a preliminary paper setting out its framework for applying capital charges to the market risk incurred by banks. In line with the Accord's original methodology, the BCBS advanced the use of a standardised method to measure market risk as the basis for applying capital (BCBS 1993). However, the US banks strongly criticised the proposals, based on the reasons eventually outlined in the BCBS's revised framework paper issued in April 1995⁵⁵. The BCBS acknowledged the criticisms predominantly from the major US banks that the proposals "did not provide sufficient incentives to improve risk management", and more to the point "were not sufficiently compatible with bank's own measurement systems" (BCBS 1995:1). Importantly for banks, the BCBS recognised the bank's core argument that "[banks'] own risk management models produced far more accurate measures of market risk" (BCBS 1995: 2).

As a result of this recognition that perhaps the banks could provide the BCBS with a technical alternative to Basel I, the BCBS conducted its own analysis of the possible use of banks' in-house models for the calculation of market risk capital and by 1996, issued a formal amendment to the Accord incorporating the internal models approach which industry "strongly

⁵⁵ See also Tarullo (2008: 63)

welcomed” (BCBS 1996). Despite built-in conservative elements such as a multiplication factor which in effect provided an additional capital ‘cushion’ to a bank’s ‘value-at risk’ (VaR) estimate⁵⁶, the general adoption of banks’ internal models became the “valuable starting point for measuring the riskiness of a bank's trading portfolio” (BCBS 1996: 3). This change was also welcomed by US regulators, who for some time had been advocating the need to keep pace with financial innovations. As then Chairman of the Federal Reserve Alan Greenspan remarked, “as financial markets change, regulators too must adapt to the new technology...[and] one example is the recent consensus reached by international banking regulators to use internal model approaches for measuring market risks at banks and allocating regulatory capital to those risks” (Greenspan 1996).

However, the adoption of internal models for market risk is more significant for the process leading to the development of Basel II. US regulators again had been publicly advocating the use of internal models for regulatory capital more generally. The Governors of the Federal Reserve had made several calls for regulators worldwide to review the out-of-date Basel Accord as well as to take into account their approach of making “greater use of the banking industry’s sound, internally developed models and practices in risk management in order to reduce regulatory burden and to improve the effectiveness of our supervision” (Phillips 1996). As Former Chairman Greenspan remarked,

“the largest U.S. banking organizations are moving into new areas of risk evaluation for internal management purposes, including the quantification of credit risk. They

⁵⁶ VaR is defined as the estimate of the likely maximum amount that could be lost on a bank’s portfolio with a certain degree of statistical confidence. BCBS (1995) page 4

have--or are developing--procedures for allocating capital against various types of loans, based on estimates of credit risk for various categories...These capital allocations, as I noted, are for internal management, not regulatory, purposes. But I am impressed with what they teach us, the regulators, and what they imply for regulatory capital...We at the Federal Reserve are beginning a review of the internal credit risk-capital allocation models of major U.S. banks in order to understand better the strengths and weaknesses of these models.” (Greenspan 1996)

Despite the Federal Reserve’s push for the regulatory adoption of the industry’s internal models, the BCBS had yet to fully embrace the idea that internal models could also be used for credit risk. The paradigm shift was in words of former BCBS Chairman Tom de Swaan still in “a developmental stage” and that although credit risk models could have prudential benefits the reality in 1998 was that “there are still serious obstacles on this road” (DeSwaan 1998). By the time the BCBS’s ‘New Capital Adequacy Framework’ was released in June 1999, there was still no sign of the Committee’s shift to internal models and “it disappointed those who favoured using internal credit ratings or credit risk models as the basis for capital regulation” (Tarullo 2008: 93).

Nevertheless, behind the scenes the BCBS had established a ‘Models Task Force’ that had been given the mandate to evaluate the option of internal models for regulatory capital purposes. In their report, the Task Force made it clear that they had been “actively engaged in gathering information about banks’ internal rating systems, and assessing both the ‘best practice’ and overall sound practice in this area” (BCBS 2000a: 2). This active engagement included a survey of 30 G-10 banking institutions as well as presentations from banks and other industry practitioners given directly to

the BCBS Task Force. This exercise not only marked the beginning of a new and more active BCBS approach to information gathering for the Basel II process, but it also signalled its intention that the BCBS's thinking would be guided by the findings from industry (BCBS 2000a) but more importantly, that it would signal the beginning of the BCBS's institutional push to adopt these models outright.

Enhancing capture through normative practices: Basel II and the adoption of internal models

The BCBS had a high demand for private technical resources at a time when firstly, domestic privacy laws made it logistically and often politically difficult to obtain information from member countries and secondly, the BCBS was faced with a high degree of international pressure to revise the outdated methodologies that characterised Basel I. The US regulators (primarily the Federal Reserve) had called upon the BCBS to take seriously the information that banks (particularly in the US) were generating for themselves, in the form of their internal models for the management of portfolio risk.

As indicated by the then Chairman De Swaan in 1998, there seemed to be little appetite among other non-US members to turn to private models as an alternative to Basel I. However, the “momentum for change strengthened” when Dutch Chairman de Swaan was succeeded by the President of the Federal Reserve Bank of New York William McDonough in June 1998 (Tarullo 2008: 91). In January 2001, the BCBS released its re-packaged Basel II (or the ‘second consultative paper referred to as CP2), which incorporated industry’s much desired goal of having an internal ratings-based (IRB) approach for regulatory capital. The approach incorporated a new ‘tiered’

framework of approaches where banks could adopt the 'Basic' or Standardised approach through to more 'Advanced' approaches depending on their level of sophistication. The underlying idea of the tiered framework is for the Basel II Framework to be 'incentive-driven'; that is, banks with more sophisticated or 'advanced' risk management capabilities and techniques would be able to hold less capital than those with less advanced risk management capabilities.

The adoption of the IRB methodologies was widely praised by the large international banks, welcoming the BCBS's progress towards "creating a capital framework that can meet the needs of a rapidly evolving banking business", which according to the IIF had been "accomplished in an atmosphere of unprecedented and close informal dialogue among banks and supervisors at the international level" (IIF 2001: 6). The joint BBA/LIBA response goes so far as applauding the BCBS for it "so obviously listened to the industry lobby and believe that the proposals, in sum, represent a substantial step toward a more risk based Accord" (BBA 2001: 3).

Whilst the political momentum for adopting market methodologies certainly changed with the Chairmanship of William McDonough, this does not sufficiently explain how Basel II would come to adopt not only the internal models paradigm but also adopt the capital incentives needed to justify its use. Specifically, one glaring issue raised by industry was that in contrast to the stated aim of the BCBS, the CP2 proposals would actually *increase* regulatory capital requirements. Even though the IRB approach was intended to provide positive incentives to banks to improve risk measurement and management of mitigants through capital reductions for

various forms of transactions that reduce risk (BCBS 2001a). This criticism launched the first of a number of Quantitative Impact Studies (QIS) undertaken by the BCBS to gauge the effect the new proposals would have on banks' capital levels.

These QIS exercises were the primary normative means through which the BCBS was able to justify and amend the proposals to provide the IRB banks with the promised capital incentives. Confirming industry criticisms, the QIS 2 and subsequent QIS 2.5 studies showed that on average, the CP2 proposals for credit risk would deliver increases in capital requirements for all groups, including the IRB banks (BCBS 2001c). As the BCBS admit, the proposals for the IRB Foundation approach would generate higher overall capital requirements than the basic 'Standardised' approach, which were "counter to the Committee's desired incentives" (BCBS 2001c: 2)⁵⁷. As a result, the BCBS used the QIS data to propose modifications to the CP2 framework in order to ensure that "the foundation IRB approach provides a modest capital incentive relative to current capital requirements" (BCBS 2001d: 3).

Based on the modifications proposed, the BCBS set out again with a QIS version '2.5' to gauge the impact of the modifications on overall capital levels. The results showed that whilst the modifications would overall reduce the credit risk capital requirements for most banks overall, the net 'incentive' disappeared when the operational risk charge was added back on (this chapter discusses the issue of the operational risk charge in the following section). Moreover, the results indicated that whilst the modifications

⁵⁷ The IRB Foundation approach would generate 14 per cent higher requirements as opposed to the 6 per cent increase under the Standardised approach.

resulted in relative declines in capital for some portfolios, the impact on other portfolios had yet to be determined, leading to the BCBS's scheduled third QIS in October 2002.

The BCBS's QIS 3 was a watershed for Basel II, as it was not only the most extensive field test of the Basel II proposals (more than 200 banks from over 40 countries participated) but it also reflected the Committee's "desire to work cooperatively with industry participants to develop practical approaches to difficult issues" (BCBS 2002: 2). In the Committee's words, the "Committee has responded to each new challenge by engaging in active dialogue with banks and other market participants, and, where possible, has tried to borrow from leading industry practice" (BCBS 2002: 1). The need for such dialogue through particularly the QIS exercises was borne from the Committee's recognition for "the need to provide tangible incentives for banks to adopt the more advanced approaches to capital measurement. The QIS 3 process is designed to provide critical information in support of these calibration efforts." (BCBS 2002: 2)

To the BCBS's satisfaction, the QIS 3 results were indeed consistent with the Committee's objectives. The revised proposals as set out in the BCBS's Third Consultative Paper (CP3) issued in April 2003 would offer an incentive for internationally active banks to adopt the more sophisticated IRB approaches and minimum capital requirements would decline relative to the Basel I levels (BCBS 2003a). The biggest winners from the revised CP3 amendments would be banks in the G10 and specifically in the EU with large retail portfolios, with reported reductions in capital of up to 20 percent. Banks adopting the more advanced IRB approach would also benefit from

reductions in capital requirements, whilst the capital requirement of those banks on the basic Standardised approach would increase. Again, despite various criticisms of many other aspects of Basel II, the general response from the major G10 international banks in relation to the modifications for the IRB approaches was favourable, appreciating the Committee's active dialogue with the industry in order to put in place a system much better aligned to the industry's measurements of risk⁵⁸.

In June 2004, the BCBS officially released 'Basel II: International Convergence of Capital Measurement and Capital Standards: a Revised Framework' (BCBS 2004a). After active consultation, dialogue and input from the industry, the BCBS had finally shifted its capital paradigm to be aligned with industry practice. The adoption of internal models and the repeated QIS exercises to obtain information that would verify the incentive structure proposed by the Committee were key examples of the BCBS's active demand for industry information and technical input.

This also exemplified the BCBS's active facilitation of private models through institutional means using primarily the QIS exercises to push the IRB approaches through. This study's framework proposed that when demand was high and corresponding threat from industry was low, institutional practices would be used by regulators to facilitate captured outcomes. The verification and adoption of capital incentives driven by data from the QIS are examples of the BCBS regulators using normative practices to facilitate capture which, in this instance, was the adoption of the internal models paradigm. The BCBS regulators were able to facilitate capture by

⁵⁸ Refer to BCBS (2003c) The New Basel Capital Accord: Comments received on the Third Consultative Paper

sourcing norms from private actors and by allowing norms to be drafted by private actors. The adoption of the internal models paradigm also exemplifies that the captured norm is one which allows private industry to self-regulate their conduct and behaviour.

The repetitive QIS data exercises to verify capital incentive structures is also an example of the way in which regulators use the policy process to facilitate capture. Specifically, the QIS exercises support the framework's proposition that in order to facilitate captured outcomes, deliberation with private actors would be undertaken throughout the policy development stage and the frequency of meetings with regulators would be increased. As a result of the deliberation, comments from private industry would then be adopted and standards changed accordingly.

Basel II is therefore significant for this case study because it was not only a complete revision of the BCBS's approach to capital regulation generally but more importantly exemplified how regulators use normative and procedural tools to support and facilitate captured outcomes. The captured outcome in this instance was the adoption of the 'internal models' paradigm used and advocated by the large international banks. As the name suggests, the internal models approach is based on the use of a bank's own estimates of risk and ratings of individual credit to calculate appropriate levels of capital for those risks. The benefits of the internal ratings approach advocated by proponents – both from the international banking sector and from regulators – were the ability of these internal systems to be more sensitive to the variations and levels of risk in a bank's portfolio (and thereby allocating regulatory capital more efficiently) and to provide incentives for

industry wide improvements in risk management practices and systems which assign the internal ratings (BCBS 2000a).

Moreover, as well as providing the BCBS with its much needed alternative to Basel I, the BCBS's authority was also enhanced by the fact that it was seen to be in touch with market realities by producing a more risk-aligned framework. More practically, the BCBS had saved time and the resources needed to come up with an alternative framework by utilising what industry had already developed. The task of 'tweaking' the model slightly to suit regulatory purposes proved not only much more efficient from the BCBS's point of view but also responded directly to pressure coming from the industry and its most vocal regulatory champion, the US Federal Reserve.

However, industry's influence over the framework of Basel II through the BCBS's adoption of internal models and its extensive information gathering exercises is part of a much larger and complex picture. Whilst industry have been pleased with the influence they have had over the BCBS adoption of the IRB methodologies, many of the same large international banks have been far from happy with other requirements imposed. This is because Basel II has also been significantly expanded, in both the level and prescriptiveness of requirements from that of Basel I, which the large international banks have fundamentally opposed⁵⁹. Basel II in comparison to Basel I now consists of what is referred to as 'three pillars': the first 'pillar' or Pillar 1 is for the most part what used to be the entire Basel I Accord and has been amended to further incorporate an operational risk charge, capital floors and calibration factors. Furthermore, Basel II also introduces two

⁵⁹ These comments are evident in both the CP2 and CP3 responses of the large US and EU banks. The IIF's publication responding to Basel II is discussed later in this chapter.

whole new sections in addition to the original Basel I content (or Pillar 1) namely ‘Pillar 2’ and ‘Pillar 3’. Pillar 2 incorporates the supervisory review and supervisory discretion of capital requirements and Pillar 3 introduces new disclosure requirements. The impact of the changes to Pillar 1 and Pillar 2 will be discussed in the following sections.

4.2 High demand, high threat: institutional constraints and the ‘creeping conservatism’ of Basel II

Constraining capture: reconstructing private norms and enhancing supervisory powers

Basel II not only includes the IRB approaches for banks to use their own risk estimates for credit risk, but the Framework has also incorporated many other requirements that directly and indirectly *increase* capital requirements. Banks have both gained through capital incentives but have also been simultaneously disadvantaged through other capital add-ons. This is somewhat contradictory to the view that banks have only gained from the revised Basel II⁶⁰. How and why has this occurred? One of the ways in which the BCBS has offset the incentives produced through the adoption of internal models has been the introduction of new norms, specifically the operational risk charge. Furthermore, Basel II also introduces ‘Pillar 2’ supervisory review, which in effect gives regulators the power to determine a bank’s capital amount over and above the bank’s own internal estimate.

One of the more controversial issues that arose throughout the Basel II process was the introduction of a new capital charge for operational risk in

⁶⁰ See for instance Wood (2005) and Tsingou (2006)

the minimum capital requirements under minimum capital requirements, referred to as 'Pillar 1'⁶¹. Prior to the first Basel II consultative paper, there were only two areas of risk covered by the minimum capital requirement, which were credit risk and market risk. Amending the original Accord to be more 'up to date' with market innovations was already a difficult endeavour, but going so far as introducing a *new* capital charge against what the banks thought to be a very qualitative and under-researched risk area was highly controversial and strongly opposed. This is quite simply because any new capital charge (let alone one which lacked definitive quantitative measurement) is considered to be an unproductive use of equity and hence a cost to banks.

The earliest indication that the banks were opposed to any specific capital charge for Operational Risk is contained in a preliminary issues paper on Operational Risk Management issued by the BCBS in 1998, which outlines the work that the BCBS had initiated in relation to its research on the practices of operational risk management in the industry (BCBS 1998). This paper was simply a fact-finding discussion on what the BCBS had found as a result of the interviews it had undertaken with approximately 30 banks from the different BCBS member countries. Importantly, the BCBS confirmed from its interviews with those banks that whilst awareness by senior management of the need to monitor operational risk was increasing, many sophisticated banks were only in the very early stages of developing an operational risk management framework. This means that banks at that early stage not only lacked the conceptual and data needs necessary to measure

⁶¹ Basel II in comparison to Basel I now consists of what is referred to as 'three pillars': the first 'pillar' or Pillar 1 is for the most part what used to be the original Basel I Accord with two main revisions – the IRB methodologies for credit risk and the additional operational risk charge

operational risk for capital purposes but that the cost and time needed to devote energies to developing such frameworks were considered significant and “in many cases, exceeded the direct costs of the operational losses” (BCBS 1998: 4).

Industry opposition to the introduction of a specific capital charge for Operational Risk is even noted in the BCBS’s finding that “most banks agreed that the process is *not sufficiently developed for the bank supervisors to mandate guidelines specifying particular measurement methodologies or quantitative limits* on [operational] risk. *Preference was expressed*, at this stage, for supervisors to *focus on qualitative improvement* in operational risk management” (BCBS 1998: 7) [emphasis added]. In short, the banks opposed *any* role for supervisors to mandate capital for operational risk, and moreover were even split on “whether the supervisors should provide a forum to facilitate the identification of ‘best practices’, with some expressing reservations about the usefulness of best practices given the perceived institution-specific nature of operational risk” (BCBS 1998: 7).

Banks therefore were not only opposed to the idea of supervisors intrusively determining their capital needs for operational risk but some were also opposed to supervisors even suggesting normative practices for managing a risk that was considered to be qualitatively specific to individual banks. In this report, banks simply noted a ‘potential’ for supervisors to raise the level of awareness of operational risk amongst banks but little else than this. The outcome of this first preliminary report was the conclusion by the BCBS that it would simply “continue to monitor developments in this area” (BCBS 1998: 7). However, this promise to simply continue monitoring

developments in the industry's management of operational risk was short lived when in June 1999 the BCBS released the first Basel II consultative paper (BCBS 1999). In this paper, the Committee proposed that that the new Accord "develop an explicit capital charge for other risks (such as operational risk)" (BCBS 1999: 10). More importantly was the Committee's belief that the new framework "should be *enlarged* so as to cover more explicitly each of these major categories of risk" (BCBS 1999: 13) [emphasis added]. The proposed enlargement of the new capital requirements was not insignificant; the BCBS was not only proposing quantitative applications for developing an operational risk charge but was also more importantly qualitative factors "such as the integrity of the controls process and internal measures of operational risk" (BCBS 1999: 15).

Despite the recognition that the industry was not adequately prepared to monitor and measure such a risk and the development of such a risk charge would be "difficult to quantify", the Committee re-affirmed its belief that "such risks are sufficiently important for banks to devote the necessary resources to quantify the level of such risks and to incorporate them into their assessment of their overall capital" and that such a risk was "too important not to be treated separately within the capital framework" (BCBS 1999: 50). It is clear that the BCBS were fully expecting both the quantification and qualification of an operational risk charge to provoke industry outcry, reflected in the BCBS's statement that "the Committee anticipates a dialogue with the industry on possible specifications" (BCBS 1999: 15). Indeed, an example was the submission from Merrill Lynch, which stated that they were not only "disappointed to see that the operational risk proposals are a core

requirement of the Pillar 1 proposals, and not a component of Pillar 2 as we argued in our response to the first consultation paper” but also argued what was to become a prevailing theme across most banks that “the imposition of capital charges is not an appropriate response to these risks...[and] moreover, are disproportionately penal.” (Merrill Lynch 2001: 2)

As confirmed in the subsequent QIS 3, even though it would appear that “the tide had been turned in favour of banks that would adopt the more advanced IRB approaches”, the actual overall capital reduction for these IRB banks was only approximately 2 per cent lower than Basel I levels (Tarullo 2008: 117). In fact, whilst credit risk capital requirements benefited from around a 14 per cent reduction in capital, the net reduction of 2 per cent resulted primarily from the capital charges for operational risk (BCBS 2003b). These results affirm the stated goal of the BCBS, which is to “broadly maintain the aggregate level of such requirements, while also providing incentives to adopt the more advanced risk-sensitive approaches of the revised Framework” (BCBS 2004a: 4). Hence, “insofar as there was continuing pressure on the committee to provide advanced IRB banks with more flexibility on operational risk, these banks could reasonably have expected even more favourable results as further changes were made” (Tarullo 2008: 117). However, this was not to eventuate and criticisms from industry had little impact on the eventual adoption of the operational risk methodologies.

Other academics such as Herring have also been highly critical of the BCBS’s inclusion of the operational risk charge into Pillar 1 minimum capital requirements. As Herring argues, “the Basel Committee is not simply

changing regulation to conform to well-established industry best-practice, as it did in market risk. It is attempting to define best practice...I believe this attempt to set capital charges for operational risk is fundamentally misguided” (2002: 5). The issue for Herring as well as industry was that “at a more fundamental level, it is unclear why the Basel Committee insists on dealing with operational risk under Pillar 1 – that is, as an issue of capital adequacy” (Herring 2002: 10).

The addition of the operational risk charge however was not the only capital add-on evident in Pillar 1. There were other indirect requirements put in place, which ran entirely counter to the incentives supposedly supplied to banks through the IRB gains. These were the imposition of somewhat arbitrary ‘prudential floors’ and ‘calibration factors’, which in effect further negate capital benefits to the IRB banks. Far from being allowed to determine their own capital needs based on their own internal economic capital models, the BCBS decided after CP2 to apply ‘prudential floors’ for banks adopting the IRB approaches, much to the astonishment of industry. The imposition of these floors meant that “beginning year-end 2006 and during the first year following implementation, IRB capital requirements for credit risk together with operational risk and market risk capital charges cannot fall below 90% of the current minimum required for credit and market risks, and, in the second year, the minimum will be 80% of this level.” (BCBS 2003a: 6) The major banks were highly opposed to these floors, with JP Morgan Chase for instance arguing that,

“We see no rationale for imposing such a floor. If a supervisor has conducted a thorough review of a bank’s rating process and capital allocation methodology, and

has concluded that the bank is ready to implement the advanced approach, then the supervisor should be willing to accept the resulting calculation of minimum capital requirements. To impose such a floor would result in our having to calculate our regulatory capital twice quarterly over a two year period – at a multi-million dollar cost – with no compelling safety and soundness benefit” (JP Morgan Chase 2003: 7-8).

JP Morgan Chase ‘strongly’ recommended that the Committee eliminate the floor.

However, the BCBS did not eliminate the floor but instead *extended* the length of time for which the floors would be applied. As they state in the final version of Basel II in June 2004, “The Committee believes it is appropriate for supervisors to apply prudential floors to banks that adopt the IRB approach for credit risk and/or the AMA for operational risk following year-end 2008. For banks that do not complete the transition to these approaches in the years specified in paragraph 46, the Committee believes it is appropriate for *supervisors to continue to apply prudential floors...to* ensure that individual bank implementations of the advanced approaches are sound.” (BCBS 2004a: 13) [emphasis added]

In addition to extending the period of time for which supervisors could potentially apply these prudential floors, the Committee also added a ‘scaling’ or calibration factor that was to be applied to the risk-weighted assets for credit risk assessed under the IRB approach. This scaling factor was intended to “broadly maintain the aggregate level of minimum capital requirements”, which again went *against* the very grain of aligning the new Accord with minimum and risk-sensitive capital (BCBS 2004a: 13). When the BCBS released a re-finalised version of Basel II in November 2005, the IIF

immediately issued a media release outlining its “serious reservations” against the scaling factor, arguing that “the industry has consistently challenged this concept because it will detract from the technical consistency and the risk sensitivity of the framework and, in fact, partially diminish the benefits of a risk-based capital system” and moreover imposing a scaling factor was “not only unnecessary but actually punitive to adequately capitalised banks.” (IIF 2005: 6)

The argument therefore that Basel II has benefited the interests of the IRB banks is difficult to reconcile with the views of private industry presented in this chapter. The IIF has repeatedly argued that the BCBS has cumulatively built in elements of ‘conservatism’ where “the conservatism of particular parameters already results in a significant distancing of regulatory-capital calculations from internal risk management and economic capital-calculations” (IIF 2005: 7). One leading industry representative confirmed in an interview that contrary to the claim that the banks have ‘captured’ the BCBS, “the feeling is much more that the regulators have hijacked what was supposed to be a bank-centred thing, and have increasingly turned it into a more and more prescriptive regulatory thing”⁶². Evidently, regulators ‘hijacking’ the Basel II process is not considered a good thing for banks.

This study proposed that evidence of regulators using institutional constraints to prevent outcomes from becoming captured are when information and private norms are sourced from industry, but ultimately this information is reconstructed by regulators to include vested interests. The inclusion of the operational risk charge illustrates this practice, where

⁶² Confidential interview with a representative from a large industry association

regulators have not only actively sourced this expertise from industry but have then used this information to create a new capital charge, which ultimately offset a large portion of the capital incentives created from the adoption of internal models. When the operational risk charge did not act to neutralise the gains made by private industry, the BCBS went further, using the QIS information to recalibrate the capital requirements so that the BCBS could “broadly maintain the aggregate level of minimum capital requirements” (BCBS 2004a: 13).

In addition to this however, the study also put forward that regulators who perceive their authority to be under threat from private norms would also resort to developing supervisory powers which enabled regulators the ability to exert their authority over industry. One issue that has been left to the sidelines of discussion on Basel II is the impact of Pillar 2 on capital levels. Pillar 2 incorporates the supervisory review of capital requirements and was in many ways recognition by the BCBS of the limitations in having ‘fixed’ capital requirements in Pillar 1. As they had experienced with the original Basel Accord, market innovations and the speed at which new financial products can be developed often outpaced regulations. In fact, as Harris (2004) has argued, regulation itself has more often than not spurred financial market innovations because those financial products are often developed primarily to circumvent those regulations in the first place.

In response to these weaknesses, the BCBS state in CP2 that “Pillar 1 has been enhanced to reflect more accurately a bank’s overall risk profile relative to the minimum capital requirement. While this more precise measurement of risk is an important step in the effort to align capital charges

more closely with underlying risk, minimum regulatory capital requirements will tend to lag market innovations, and they will not fully capture all elements of risk that are specific to an individual bank's risk profile." (BCBS 2001a: 4) The solution to this ongoing problem of regulatory lag therefore was the 'supervisory review' tool, which, whilst based strictly on principles, empowered regulators to not only monitor a bank's application of its capital requirements but also, to intervene if and when a bank's capital level was deemed insufficient to act as a buffer against their relative risks. This means that Pillar 2 allows regulators to determine what types of risks could be deemed to attract capital *over and above* Pillar 1.

When the BCBS released its first detailed version of Pillar 2 in CP2, most banks were not surprised with what was outlined. The four principles contained in Pillar 2 were for the most part similar to the BCBS's 'Core Principles for Effective Supervision' which alongside the Basel I Capital Accord, had been another major standard-setting area which had been ongoing since 1992⁶³. However, what some banks objected to were the inclusions of principles three and four. These principles affirmed the Committee's view that 'Supervisors should expect banks to operate above the minimum regulatory capital ratios and should have the ability to require banks to hold capital in excess of the minimum' and that "Supervisors should seek to intervene at an early stage to prevent capital from falling below the minimum levels required to support the risk characteristics of a particular bank and should require rapid remedial action if capital is not maintained or restored." (BCBS 2001a: Principle Four)

⁶³ For various versions of the Core Principles for Effective Supervision, refer to BCBC website http://www.bis.org/list/bcbs/tid_25/index.htm

Even though some regulators around the world are already empowered to mandate these specific principles within their home jurisdictions, and these principles are already contained in the BCBS's 'Core Principles', banks objected to the addition of these principles specifically to the Capital Accord. This was based on the concern that Pillar 2 legitimately gave rise to the possibility that based on these principles supervisors could require banks to hold capital over and above the already enlarged Pillar 1 requirements. As Merrill Lynch argued, "if Pillar 1 represented a truly *de minimis* capital charge and supervisors were flexible in the interpretation of Pillar 2, this would mitigate this concern. However, as currently constituted, Pillar 1 results in charges considerably higher than economic capital models indicate, and is framed much more prescriptively than economic capital practice. Moreover, Pillar 2, as currently framed, can only *increase* capital." (2001: 16) [emphasis added] The BBA/LIBA also argued that "the improved risk sensitivity of Pillar 1 makes any routine requirements for banks to hold capital in excess of the minimum unjustifiable." (2001: 66) More concerning to some was the possibility that an unbridled use of Pillar 2 by regulators around the world would not only render Pillar 1 obsolete but also cause serious level playing field issues with respect the different applications of capital requirements based on 'supervisory discretion'⁶⁴.

Despite the concerns raised in the CP2 round of consultations, it soon emerged with the release of CP3 that Pillar 2 had not only remained unchanged but more astonishingly had actually *expanded* the scope of supervisory review. Specifically, numerous issues that had emerged from

⁶⁴ For example the IIF, UBS and the Financial Roundtable expressed these concerns in CP2 comments. Refer BCBS (2001a)

Pillar 1 discussions soon found their way into Pillar 2, with a whole new section added by the time the Committee issued a revised framework for CP3. This section, titled ‘Specific issues to be addressed under the supervisory review process’ not only broadened the scope of supervisory principles but also went as far as explicitly stating that the purpose of the new section was to cover aspects that could not otherwise be addressed under Pillar 1 (BCBS 2003a).

According to the BCBS, “the Committee has identified a number of important issues that banks and supervisors should particularly focus on when carrying out the supervisory review process. These issues include some key risks which are not directly addressed under Pillar 1 and important assessments that supervisors should make to ensure the proper functioning of certain aspects of Pillar 1.” (BCBS 2003a: 145) Put simply, whatever couldn’t be agreed upon as a *minimum* level requirement within Pillar 1 ended up within Pillar 2 supervisory discretion. These issue areas for instance were not just broad ‘principles’ but almost explicit capital requirements that superiors were expected to add on to the Pillar 1 calculation. For example, one highly contested issue was whether interest rate risk should be included in the banking book. The BCBS state in Pillar 2 that despite comments from industry, the “Committee remains convinced that interest rate risk in the banking book is a potentially significant risk which merits support from capital.” (BCBS 2003a: 165)

This expansion further increased banks’ concerns that Pillar 2 was fast becoming an additional and somewhat unlimited means of imposing capital. The G10 banks were significantly opposed and some even outraged by what

was described by one bank to be a substantial “scope creep” in Pillar 2 from the January 2001 draft of the new Accord (ANZ 2003: 21). The Belgium Bankers Association argued that Pillar 2 “must not be used as a compensation for structural shortcomings of Pillar 1, which specifies the general calculation of the capital requirements.” (2003: 2) ANZ further argued that the proposed coverage of Pillar 2 was not only expanding but that the current draft went “well beyond” its original intention by mandating the capital that should be held for specific transactional issues which would result in “higher than current capital levels which would be contrary to the expressed intent of the reform process.” (2003: 21) The BBA/LIBA also opposed the ‘blurring’ of the boundary between Pillar 1 and Pillar 2 and “the introduction into Pillar 2 of elements that are intended to have “teeth”” (BBA/LIBA 2003: 19).

The IIF too objected outright, arguing that there was “insufficient differentiation” that existed between Pillar 1 and Pillar 2, further questioning “the appropriateness of establishing additional system-wide regulatory capital buffers for all banks different than the ones already included under Pillar One.” (2003: 38-39) UBS also argued that “for a bank with sound internal practices and standards, the capital calculated under Pillar I should constitute the regulatory capital requirement, with no further buffer...regulators should generally not determine the level of capital that a bank should hold in excess of the regulatory minimum, as this is a strategic decision and the responsibility of the bank’s management” (2003: 3). Finally, the Japanese Bankers Association quite simply and bluntly stated that “we

cannot accept greater capital requirements under the treatment currently required in Pillar 2.” (2003: 3)

Despite these very strong submissions which even culminated in a joint letter by all G10 banking associations to the Committee arguing against such intrusiveness⁶⁵, there were no substantive changes made to the revised framework issued by the BCBS in June 2004 (BCBS 2004a). All the additional specific supervisory issues mandated for regulatory attention remained. Furthermore, the Committee issued a statement accompanying the release of the June 2004 framework, reaffirming that “it is critical that the minimum capital requirements of the first pillar be accompanied by a robust implementation of the second, including efforts by banks to assess their capital adequacy and by supervisors to review such assessments.” Furthermore, “more generally, under the second pillar, supervisors should expect banks to operate above minimum regulatory capital levels.” (BCBS 2004a)

Whilst the intention and objective of Pillar 2 was for there to be continual dialogue between regulators and industry, particularly in relation to the IRB methods applied by the large banks, what is evident is that Pillar 2 became the means by which to facilitate the varying demands of the BCBS members. The subsequent revisions to Pillar 2 were not only the result of the inability of the BCBS to reach consensus on whether particular risks should also be included into Pillar 1 – interest rate risk being one such area, but these revisions have allowed supervisors to determine for themselves what risks should appropriately be identified and managed by way of a capital

⁶⁵ This letter is cited by a number of banking associations including the BBA and EBF, found at BCBS (2003c)

charge. In fact, the inclusions into Pillar 2 exemplify the BCBS's contradictory approach to capital more generally, where it has advocated on the one hand that aggregate capital levels should remain broadly unchanged from Basel I levels and on the other hand, that the new Basel II framework should create capital incentives by way of capital reductions for banks adopting the IRB models⁶⁶. As Tarullo argues "the committee has not elaborated on how these potentially conflicting goals are to be reconciled" (2008: 160).

In sum, Basel II has been marred by what one private industry insider has referred to as 'creeping conservatism'⁶⁷. The estimated costs associated with this regulatory conservatism have not been considered 'beneficial' to the interests of the large banks who have stressed throughout the Basel II amendment process that there is a need to align regulatory capital requirements with the internal economic capital that banks estimate for themselves. What is clear from the analysis of the Basel II process is that whilst the BCBS was initially open to making the Framework 'incentive-based' and risk-driven, it progressively made the Accord much more prescriptive and aligned with the interests of certain regulators. The following section outlines why, and which regulators, perceived their authority to be under threat, leading those regulators to resort to institutional constraints.

Why the regulatory threat? Supervisory 'tug of norms', US fragmentation and EU power of the policy process

The BCBS has engaged in close and cooperative dialogue with industry throughout the Basel II process, but this dialogue has also been influenced by

⁶⁶ BCBS (2004), paragraph 14; see also Tarullo (2008: 160)

⁶⁷ This was from confidential interviews with a private industry association undertaken in 2006.

the subsequent disagreements between BCBS members over issues concerning capital levels and the impact that the new approaches would have on their domestic constituents. In the case of Basel II we can see two distinct stages of influence: firstly where private industry has had access to and has been able to influence the initial stages of shaping the language, discourse or the ‘norms’ of standards, and secondly where institutional constraints imposed during the policy process have been more influential in affecting the latter stages and hence outcomes of policy norms. What has therefore gone in to the ‘policy machinery’ has not necessarily come out the same way. Thus, despite the initial influence of these private norms and preferences, they have not been influential enough to survive the process of deliberation or bring about changes that promote their preferences.

As discussed earlier, we can see the use of institutional constraints through the reconstruction of norms occurring in the case of the operational risk charge. The decision to include operational risk in Pillar 1 capital requirements ironically stemmed from the fact that the Committee knew that the industry had commenced work on identifying and potentially measuring Operational Risk for internal risk management purposes⁶⁸. The BCBS had decided that the industry could play an important role in initially shaping this new norm with their expertise and importantly – their resources. This is evident when the BCBS in its first Basel II consultative paper in 1999 explicitly invited banks to provide what they saw as approaches towards measuring operational risk for capital purposes. Specifically, it actively encouraged “submissions from banks that perceive their models to be functioning well” (BCBS 1999: 51).

⁶⁸ Based on confidential interviews with BCBS conducted in 2006

Industry also recognised this immediately, seeing the invitation at the very early stages of deliberation as a key opportunity to try and influence the norm by advocating their specific models in order to gain a competitive edge over others. Most influential in this area has been the collaboration between the Risk Management Association (RMA), ISDA and the BBA with their publication in December 1999 titled ‘Operational Risk Management—The New Frontier’. They acknowledged ‘increased regulatory interest’ and because of this interest recognised that the development and practice of operational risk management represented an opportunity for institutions to make their mark in this new field of risk (ISDA 1999). The industry associations jointly conclude that the ‘window of opportunity’ made it imperative for institutions to allocate resources to operational risk, in order to create competitive advantage (ISDA 1999).

This type of selective consultation with industry is often interpreted as being indicative of the close relationship the BCBS has with industry and as a result outcomes are then assumed to be captured. Indeed, selective consultation was a mechanism used by the BCBS to primarily obtain information from industry. This initial stage in the formation of policy norms is reflective of the ‘supply and demand’ of regulation, where private industry has the resources and expertise to provide regulators with information that regulators would not necessarily have. However, obtaining information from private industry is very different from what then happens to that information once it is obtained. This is the missing key variable to public-private interaction: a close relationship between public and private actors may mean increased interaction and dialogue but ‘closeness’ doesn’t mean ‘capture’.

One major industry association confirmed that the BCBS is often very open in the initial stages of policy formation in order to obtain information from industry and as such, they will actively develop position papers and propose working solutions to make it easier for the BCBS to simply ‘adopt’ outright. Though when asked if the Committee did simply adopt their position, the response was that in some instances “they basically didn’t buy any of our points” and in others, “they have adopted what is basically a more conservative version of what we’ve proposed”⁶⁹. Once papers are submitted to the BCBS, the industry representative admits that they have no control over what the BCBS then does with that information and “then there is a relatively long period where they go off and finalise the final version and [then], it kind of arrives in an email and that’s how we find out where they ended up...”⁷⁰

Even personal relationships with key members of the BCBS do not seem to help in influencing the process, the major industry association representative admitting that his contact was “not going to give me the final paper until it is signed off, he kind of just gave me a sense of where it may be and may not be”⁷¹. Moreover, they also admitted that once a paper was finalised that there would be no way that the BCBS would then change their views, despite vocal and written objections⁷². Policy deliberation and policy outcomes are therefore not only about the initial and somewhat preferential collection of information but they are also more importantly about the subsequent interpretation and use of that information. Put simply,

⁶⁹ Based on confidential interviews with a large industry association

⁷⁰ Ibid

⁷¹ Ibid

⁷² Ibid

information can be significantly altered and to use Lindblom's expression 'reconstructed' as a result of it being fed into the policy machinery.

Why then, did the BCBS proceed with the inclusion of operational risk within Pillar 1? The decision to include operational risk in Pillar 1 was from the outset highly opposed by the US as a result of fierce domestic US bank lobbying and the issue of whether or not to include operational risk underwent intense debate within the BCBS⁷³. Nevertheless, the BCBS had reached the conclusion that because some large international banks were already looking at the quantification of operational risk in the late 1990s, that it would be imperative for the Committee to be forward thinking and utilise the bank's evolving methodology early on in the process⁷⁴. Former Chair of the BCBS Tom de Swaan made it fairly clear in 1998 that "awareness of, for instance, operational, legal and reputational risks among banks seems to be increasing. Some banks are already putting substantial efforts into data collection and quantification of these risks. Not surprisingly then that the Basel Committee will also be considering the treatment of the risks that are implicitly covered by the Accord..." (1998: 1).

Aside from the reasoning that the BCBS was in effect keeping up with industry developments, it appears to be no coincidence that the issue of including operational risk in Pillar 1 as a capital requirement coincided with the very vocal push from the US regulators and US banks for the BCBS to adopt the IRB methodologies⁷⁵. The operational risk charge appears to be

⁷³ Based on confidential interviews conducted in 2006.

⁷⁴ Ibid.

⁷⁵ Interview sources would not comment on which members of the BCBS were supportive of the operational risk charge; they only commented on the fact that the US were very much against the operational risk charge. As a result, this study deduces that the push to include operational risk may have come from the European Members.

somewhat of an 'offset' to the incentives that the large banks would gain from using their own IRB estimates so that in line with the BCBS's intention, overall capital would neither increase nor decrease from Basel I levels⁷⁶. In fact, as the QIS data revealed in the first major exercise (QIS 2 and 2.5) the capital incentives purportedly gained from the adoption of the IRB approaches were completely nullified by the addition of the operational risk charge. As a result, the BCBS attracted widespread criticisms from both regulators and industry alike, arguing that the 20% operational risk charge was arbitrarily high and lacked any sound methodological justification⁷⁷.

Given the widespread criticism of the operational risk charge, the BCBS may have considered dropping the charge from Pillar 1 and instead place the more qualitative risk under Pillar 2 supervisory discretion⁷⁸. Instead, what we see subsequent to the QIS 2 exercises is 8 major consultative stages and papers since its inception in September 1998 through to the final version of the Accord, published in June 2006. Over this time, even though the BCBS has attempted to respond to industry criticisms by making modifications to the operational risk methodology, it has stuck to its conviction that the operational risk charge remain in Pillar 1 as a minimum capital requirement.

⁷⁶ This intention is stated in most of the consultative papers as well as in the QIS impact studies. For instance the BCBS states in its Overview of QIS 3 that "the Committee is not intending for the revisions to result in material increases or decreases in aggregate banking system minimum capital levels". Refer BCBS (2003)

⁷⁷ The American, Austrian, Belgium, British, Dutch, European, Finnish, French, Japanese, Latin American, Spanish, and Swedish Banking Associations, as well as the major international associations such as the IIF, ISDA and the Financial Roundtable – to name a few – were all unanimously opposed to the capital charge of 20%, with some suggesting a significant reduction to others demanding it be abolished altogether; regulators from Australia, Austria, Bahrain, Argentina, Mexico, Thailand, the US, Europe, Iceland, Korea, Finland, Guernsey, Hong Kong, Hungary, Slovakia, Poland, India, Saudi Arabia and Chile had all made specific objections to the proposed operational risk charge saying that the figure was not going to be workable within their respective jurisdictions. These were submissions made during the CP 2 deliberations. Refer BCBS (2001a)

⁷⁸ Pillar 2 of Basel II incorporates the supervisory review of capital requirements specific to banks within national jurisdictions. The effects of Pillar 2 are discussed later in this chapter.

Thus, whilst the BCBS welcomed input from private industry on ways to improve the capital framework, it was ultimately the impact of the proposals advocated by private industry that would eventually cause internal disagreements and divisions between the BCBS members, most notably between the EU and the US. As Tarullo argues, the underlying problem that has marred the Basel II process from the beginning is the lack of any strategic clarity by the BCBS members on the desired outcome for Basel II. Unlike the first Basel Accord, which was based on a pre-determined bilateral agreement between the US and UK, the Basel II process began without any clear proposals from any of the BCBS members (Tarullo 2008). As a result, the process has been significantly influenced by the domestic prerogatives of the BCBS members.

In the case of the EU, one major consideration for European regulators throughout the Basel II process has been the simultaneous process of negotiating the revised EU capital adequacy directive (CAD) (Tarullo 2008). Furthermore, the Europeans are also said to rely less on ad hoc interactions with banks as is characterised in the UK and US regulatory systems and more on external audits of bank compliance with capital standards. As a result “regulators from the continental European countries had a dual incentive to seek more, rather than less, detail in the Basel arrangement (Tarullo 2008: 118). On the other hand, for the US rules-based system where international agreements adopted by the US are automatically incorporated into domestic legislation, the onerous details and increased requirements for capital was also a serious threat to US regulators. The capital requirements being proposed were not only increasingly incompatible

with the risk practices and profiles of the US banks but the US regulators were also coming under increasing pressure from the US Congress on the impact that the new Basel II requirements would have on their domestic constituencies (read US banks) (Tarullo 2008).

Disagreements and domestic political differences are not unique in any international negotiation. The consensus decision rule in the BCBS committees was the key factor for what one BCBS official called the inevitable 'horse-trading' among members for essentially what went in and what stayed out of Basel II⁷⁹. It was in the author's view, no coincidence that the inclusion of operational risk in Pillar 1 under the Dutch Chairmanship of Tom de Swaan occurred at the same time as the increasing pressure from the US regulators for the BCBS to adopt the IRB methodologies. When the IRB methodologies were adopted under Chairman McDonough, the adoption of the operational risk charge was, it appeared, a strategically targeted 'offset' to appease non-US members. There were further disagreements between members concerning the impact that the new proposals would have on capital levels, even after the final Basel II framework was released in 2004. This was evident when the BCBS reluctantly supported another round of QIS exercises, referred to as QIS 4, where only a number of countries namely the US, Germany and Japan undertook their own national field test exercises. As stated by the BCBS, "several member countries decided to conduct a further national impact study or field test during 2004 or 2005. These exercises did not represent a joint effort of the Basel Committee on Banking Supervision, and the details varied significantly across countries" (BCBS 2004b).

⁷⁹ Based on confidential interviews conducted in 2006.

However, despite the negotiations, what is evident in the case of Basel II is that it has, in effect, appeased the European regulators' need for detail. Basel II has become a complex set of rules that is over 347 pages long, compared to the 30 pages of requirements under the original Basel I Accord. This over-complexity and the associated compliance costs for banks have in many ways offset the advantages gained from the capital incentives produced through the adoption of internal models⁸⁰. The increased prescriptiveness and complexity led to the US's decision to not only delay full implementation of Basel II for all its banks but also for its subsequent decision to adopt 'Basel IA'. The US not only allowed many of its smaller banks to continue applying the Basel I rules, but also developed their own less complex version of Basel II that was considered more appropriate for their institutions. As the former Governor of the federal Reserve Susan Bies stated "Basel IA is intended as an option for the wide range of institutions that will not be adopting the advanced approaches of Basel II...The goal is to improve the Basel I standards by making them somewhat more risk sensitive while at the same time retaining a relatively simple and straightforward approach suitable for all but the largest and most complex institutions." (US Federal Reserve 2006)

⁸⁰ One of main criticisms of the international banks was that the new rules would impose a significant increase in compliance costs associated with implementing, monitoring and adhering to the new Basel II rules. For instance, the costs associated with implementing the advanced approaches have been argued by the banks to outweigh the supposed 'reductions' in capital that advanced banks are said to benefit from. For example, the IIF argued that "the compliance costs associated with implementing the new capital framework are expected to be extremely large. Here banks refer specifically and only to the personnel and information technology costs associated with building global internal rating systems within a defined period of time (two to three years)." The Financial Services Roundtable also reiterated in significant detail the costs of implementing Basel II for their members, arguing "the monetary cost of complying with the Basel II rules will be significant. One of our members has estimated that initial costs will be USD 70 million to 100 million just to implement the system, plus multi-million dollar ongoing costs. If one multiplies these costs by the thousands of banks around the World, this will amount to many billions of dollars of additional costs." Credit Suisse also estimated that "the precise additional cost of Basel II will no doubt be in the hundreds of USD billions for the banking community. If the benefits / risk mitigation number do not reach these figures, Basel II will have failed". Comments found at the BCBS CP2 and CP3 submissions.

The question that remains is why have the European BCBS members been able to include more of these details, despite US opposition and eventual ‘defection’ from the agreement? The simple answer is that the EU has been able to exercise considerable power over the Basel II policy process, through the BCBS committee structure. Simultaneously, the EU members have been able to do this due largely to the way in which the interests of the five US regulatory agencies⁸¹ responsible for bank regulation have been fragmented throughout the Basel II process. This has weakened the ability of the US to present a ‘united’ front on proposals.

The EU’s power over the institutional structure and policy process of the BCBS stems largely from the way in which EU members have dominated the committee and sub-committee structure, where key positions are occupied by regulators from the EU. This study has proposed that another mechanism for regulators to successfully impose constraints is through the decision structure. For instance, the current Chairs of the four main BCBS committees are from the EU⁸². As discussed earlier in this chapter, Chairs and BCBS members also have an incentive to make sure that regulators from their domestic agencies are included in each of the sub-committees. The consequence of the sheer number of EU members means that each sub-committee would also correspondingly consist largely of EU members. European regulators have therefore been able to include more detail in Basel II based on their domestic CAD prerogatives, primarily through the policy revision process.

⁸¹ The five agencies responsible for banking regulation in the US are the Federal Reserve, the Treasury, the Office of the Comptroller of the Currency, the Office of Thrift Supervision and the Federal Deposit Insurance Corporation.

⁸² Refer to current BCBS organisation chart found at <http://www.bis.org/bcbs/organigram.pdf>.

As there were often no obvious solutions for many of the complex and technical issues that arose as a result of extensive deliberation with industry and other regulators, the various sub-committees responsible for different issue areas (largely populated by European regulatory staff⁸³) would incorporate solutions that EU regulators had already discussed at the EU level of deliberation for the purposes of the CAD. These proposals were then fed through the sub-committee chain, also largely dominated by European regulators, who would already be familiar with the solutions put forward by their respective working group members. Consensus on this basis was therefore much easier to achieve, due largely to the fact that the EU regulators were for the most part familiar with solutions that had already been agreed to for the purposes of the CAD.

This however was markedly different in the case of the US regulators. As Tarullo argues, the disagreements and inconsistencies between the five major US regulators have been the major stumbling block for the ability of the US to influence the direction of Basel II. Despite the fact that the adoption of IRB methodologies was primarily championed by the US, Tarullo argues that there were considerable disagreements between the agencies on whether the US banks and banking supervisors were feasibly able and ready to adopt the new approach. The House Financial Services Committee also went so far as introducing a bill requiring the agencies to develop a unified position on Basel issues, giving the US Treasury the default position if they could not determine one (Tarullo 2008: 120).

⁸³ For example, refer to current BCBS organisation chart found at <http://www.bis.org/bcbs/organigram.pdf>. The current Chairs of the four major sub-committees are from the EU.

As a result therefore of the EU's power over the policy process and US disunity, there was in accordance with one BCBS official a 'blocking minority' where if a number of members – which would include a combination of either the US, UK, France, Germany and Japan – were unified in their opposition to a particular issue, that this would alone veto the issue outright or send it back to the sub-committee drawing board⁸⁴. This process was continued, such that each Basel II output became a patchwork of ad hoc policy proposals incrementally built into the overall framework. This is by far the most overarching criticism made by the banks (particularly from the US) that have argued that Basel II has been marred by an enormous and complex set of rules and requirements, qualifications for the ability to use different methodologies and differing charges for different portfolios – all in the name of making Basel II more 'risk sensitive' and better aligned to market practice. The US decision to develop Basel IA was testament to this criticism. The consensus decision rule and the associated policy processes caused extensive delays in producing revised consultative papers, which would build in cumulatively more and more detail in order to appease predominantly the European regulators of the BCBS. It took on average two years for the BCBS to revise each consultative paper and release it for further consultation.

The Basel II process of revision has therefore been highly influential in the way in which it has affected policy outcomes. Internal divisions within the Committee would trigger continual rounds of policy negotiations within the sub-committees that would take into account various and competing norms in order to produce outcomes that could be agreed to by the BCBS members, regardless of whether the end product was technically feasible or

⁸⁴ Based on confidential interviews conducted with the BCBS in 2006

not. The Basel II policy process became the causal mechanism between the initial acceptance of IRB models, to the eventual adoption of other norms that served to counter the capital incentives gained by the large international banks. Even though the BCBS had a strong demand for the private methodologies in order for the BCBS to produce a more risk-sensitive capital framework, the impact of these proposals on member jurisdictions ultimately gave rise to internal divisions, which would then be played out through various revisions and ad hoc policy proposals.

One problematic aspect of the Basel Framework is that it is very difficult to categorically call it an 'outcome' because even at the time of writing, Basel II is still being changed, amended, and moulded in response to various factors⁸⁵. It is a moving target and one in which has been susceptible to various influences, including pressure from private industry. In fact, critics have argued that the BCBS had no strategic direction in mind when undertaking the Basel II exercise and a lot of the cognitive frameworks produced resulted from the various different sub-committee working groups and their own internal consultation processes. As Tarullo argues, "the cumulative effect of so many alterations was helpful neither to the committee's credibility nor to the coherence of its proposals...Committee members seemed aware of the effects of their activities but were apparently unable to change course" (2008: 114).

⁸⁵ The BCBS released their final 'Basel II Enhancements' in July 2009 in response to the weaknesses revealed by the global financial crisis. The capital requirements are also undergoing intense revision at the time of writing and is a key agenda item for the G20 and the Financial Stability Board. See BCBS website press release on 7 September 2009 <http://www.bis.org/press/p090907.htm>

4.3 Conclusion

The BCBS and its important capital framework Basel II has involved a high degree of private influence, by way of the BCBS openly engaging with industry and its subsequent adoption of market generated methodologies as part of its revised capital paradigm. As an important stakeholder, input from the industry has been actively sought by the BCBS through its deliberation and QIS field exercises. This information has been extremely important for the numerous revisions to the capital requirements and to the internal model methodologies, which created capital incentives for the large international banks. However, at the same time as the BCBS' intention of producing capital incentives, the BCBS has also built in elements into Basel II that reduce these incentives and in some instances increase the capital levels. The result of these competing influences is that the Basel II framework has not only veered somewhat indiscriminately towards the version that we see today, but these same competing pressures, in conjunction with extraordinary events such as the global financial crisis, continue to influence the evolution of Basel II. Private discursive influence therefore is important but, within the wider context of international banking regulation, is only a part of a more complex international policy framework.

5

The International Association of Insurance Supervisors and the ‘included exclusion’ of Private Observers

The International Association of Insurance Supervisors (IAIS) has become an integral part of the global architecture for the regulation of insurance firms. Like the Basel Committee on Banking Supervision (BCBS), the IAIS’s headquarters are based at the Bank for International Settlements (BIS) in Basel, Switzerland and is recognised by insurance regulators around the world to be a key international standard setter for its industry. Alongside the BCBS and the International Organisation of Securities Commissions (IOSCO), the IAIS is also the third peak body of the Joint Forum for the regulation of conglomerate firms⁸⁶ and, like its two peers, the IAIS’s standards and principles are used as the blueprint for assessment under the joint International Monetary Fund (IMF) and World Bank Financial Sector Assessment Programs (FSAP)⁸⁷.

However, unlike its two major peers, little is known about this organisation despite its mandate and standing in international standard-setting circles. This relative obscurity may be due to the fact that it is a comparatively new international standards organisation, established only in 1994. What is more interesting about this organisation is how different it is compared to its nearest neighbour the BCBS. In fact, the IAIS is unlike the BCBS in many ways, including its size, its broader mandate and most

⁸⁶ For information on the Joint Forum, refer to <http://www.bis.org/bcbs/jointforum.htm>

⁸⁷ For more information on the FSAP, refer to <http://www.imf.org/external/np/fsap/fsap.asp>

importantly, its membership profile. These differences have contributed significantly to the way in which the IAIS has interacted with private actors and consequently, the type of private influence evident in the case of the IAIS.

As a result of the unique circumstances that surrounded the establishment of the IAIS, this chapter argues that there has been a high demand by regulators for private material resources and technical expertise. The material resources of private actors were used by the regulators of the IAIS to secure its initial and continued viability as an international organisation. As a result, private actors gained important concessions in the form of membership, information and access to decision making forums. The IAIS also sought the technical expertise of private industry in order to develop international standards at a relatively rapid pace. As already outlined, the IAIS was a relatively new standard-setting organisation and in comparison to its nearest peer, the BCBS, it was also some way behind in producing comparable international standards.

Nevertheless, despite this supply and demand of private resources and capabilities, this chapter finds that demand for private material resources and technical capabilities dropped once the material viability and the international standing of the IAIS was secured. When this occurred, regulators of the IAIS (or IAIS 'Members') put in place institutional constraints that structured their interaction with private actors as well as restricted their access and input in to decision forums. This is because certain regulators of the IAIS (namely from the European Union (EU)) perceived that their authority was being undermined by the participation of private actors in 'regulatory' forums. Other considerations such as political pressures

generated by the development of the Solvency II project in the EU (Solvency II) were also factors that led regulators to create the ‘included exclusion’ of private actors. As a result, this chapter shows that like the case of the BCBS, the IAIS has also been a case of both capture and constraint, resulting from high demand but a corresponding increase in perceived threat from private industry.

5.1 High demand, low threat: the introduction of Observers and capture in the IAIS

The establishment of the IAIS and the supply and demand for private resources

The relatively humble beginnings of the IAIS have played a significant role not only in the way in which the organisation has evolved but more importantly for the way in which its relationship with private actors developed. The circumstances of being a relatively new international institution charged with the task of developing standards in a comparatively new field of insurance regulation gave rise to the IAIS’s need for material support and technical resources, which ultimately paved the way for private actors to fulfil.

The IAIS was formally established as an international standard-setting body in 1994⁸⁸. It has regulatory representation from 180 jurisdictions and formal membership is granted only to insurance regulators and supervisors who become active participants in the organisation’s activities. This means that only regulators of the IAIS are granted decision making power through

⁸⁸ For more information see website www.iasbweb.org

the right to vote on outcomes. Members must pay an annual fee which forms the majority of the IAIS's budget. However in addition to this membership base, information on their public website also states that "Since 1999, the IAIS has welcomed insurance professionals as Observers. Currently there are more than 100 Observers representing industry associations, professional associations, insurers and reinsurers, consultants and international financial institutions."⁸⁹ In fact, the vast majority of those industry Observers originate from the G10 and include the world's largest insurance companies such as the American Insurance Group (AIG), Allianz AG, ING Group, Munich Re and Swiss Re⁹⁰.

The IAIS's rationale for introducing the new membership category 'Observers' was to promote "sound insurance markets and to contribute to financial stability around the world" by making sure that its standards had sufficient 'buy-in' by all relevant bodies – relevant bodies being both regulators and firms which ultimately implement them. Thus, in the words of the IAIS, membership is "open to all those who are not regulators but who are interested in contributing to the work of the IAIS, for example insurance companies, insurance brokers or accounting firms."⁹¹

A brief examination of how the IAIS came about goes some way in explaining why Observer members were invited to participate in IAIS activities. Ten years prior to the formal establishment of the international body, a small number of insurance regulators from around the world started to attend the annual meetings of the National Association of Insurance

⁸⁹ From the IAIS website 'About the IAIS' <http://www.iaisweb.org/index.cfm?pageID=28>

⁹⁰ For full list of Observers refer IAIS website <http://www.iaisweb.org/index.cfm?pageID=417>

⁹¹ From the IAIS website 'How to Join' <http://www.iaisweb.org/index.cfm?pageID=29>

Commissioners (NAIC) in the United States (US) for the primary purpose of exchanging information with the US insurance commissioners on cross-border transactions and exchanges⁹². Aside from the NAIC meetings, there were no other forums in which insurance regulators around the world could interact and potentially cooperate. In the years leading up to the inception of the IAIS, international participation in the NAIC meetings continued to grow, and by 1989 regulators recognised the need for a more formal international association separate from that of the US and began pushing for an international forum of their own⁹³. The most obvious and logical choice for locating such an organisation was alongside the long standing banking standard-setter and under the wings of the BIS.

However, unlike the resources available to the G10 central bankers which made up the BCBS at the time, the initial financial backing of the IAIS was much less stable. The BIS agreed for instance to provide space for the IAIS's permanent Secretariat at its headquarters in Basel but since 1994, these offices have been located in the basement adjacent to the main tower where the BIS and BCBS staff are located. In fact the IAIS headquarters were often sarcastically referred to as 'the car park'⁹⁴. In addition, the BIS also agreed to subsidise the IAIS with 'support in kind' by providing its conference facilities within the BIS, hardware such as computers and furniture and its internal systems (such as processing staff payroll). Aside from this support, there has been no other direct financial support given to the IAIS from the

⁹² From an internal IAIS newsletter in 2003; this newsletter is for Members only and is not available for public viewing.

⁹³ Based on confidential interviews with a long standing member of the IAIS who had been involved with the IAIS since its inception in 1994; all references to confidential interviews with Members of the IAIS refer to one or more of the 16 Members interviewed for this study between 2006-2009

⁹⁴ These comments were confidentially made by non-IAIS officials and also observed by the author directly; it should also be noted that renovations are currently underway so that the increasing number of staff can be housed at the BIS; however this does not guarantee that the IAIS staff will be moved.

BIS⁹⁵. As a consequence, the financial viability of the organisation rested entirely on membership contributions and donations of staff by member regulators to work for the Secretariat through external secondments, which meant that they were paying for these staff in addition to their membership fees⁹⁶.

This was an uneasy financial foundation for IAIS for two main reasons. Firstly, insurance regulators at the time had much less budget to spend on activities outside their own jurisdictions compared to their wealthier banking and central bank colleagues (and arguably still do to date). Subsidising an international organisation meant less public funding to spend on domestic regulation. Secondly, because of the way in which the US insurance market and regulations are structured, the IAIS was predominantly funded by the US. To elaborate, the US is not one of the IAIS's 180 jurisdictions but over 50 of the member jurisdictions. This is because each state in the US is sovereign when it comes to insurance regulation. Consequently, because the US was treated as over 50 members, it was also paying for over 50 membership fees and hence largely supporting the organisation's funding base.

However, paying 50 membership fees did not in return grant the US 50 voting rights. Instead, the NAIC⁹⁷ - an umbrella organisation for each of the US state insurance Commissioners - was given the right under the IAIS's By-Laws to designate up to a maximum of 15 of its members "who may

⁹⁵ Based on confidential interviews with a long standing member of the IAIS

⁹⁶ Confirmed in interviews with Members of the IAIS.

⁹⁷ The NAIC has itself had a large standardisation challenge of its own, trying to align the insurance regulations of all its states which have historically varied. Based on interviews with the NAIC.

exercise their rights to vote”⁹⁸. There was apparently no science to the exact figure of 15 votes but was considered a proportionately fair number relative to the overall number of members at the time⁹⁹. However, the author presumes that it is not coincidental that the number of EU members in 1995 was exactly 15¹⁰⁰, hence the proportionately fair 15 votes granted to the NAIC.

The US jurisdictions as well as the other member jurisdictions were therefore always conscious of the funding structure versus the voting structure of the organisation. This created some tensions between the ways in which the United States of America and the ‘united states’ of Europe approached regulatory matters. The most immediate tension that arose from the conception of the IAIS came from the US’s vocal support for the IAIS to not only consult with private industry but to have private industry directly involved in the IAIS’s activities, the argument largely centring on the need for market practitioners to buy-in to the IAIS’s standards¹⁰¹. However, the reason for the US’s strong support for the idea of private market participation again goes back to the special nature of the US State Insurance Commissioners.

For a start, the Insurance Commissioners are quite different from the prudential regulatory authorities that are predominant in most of the other IAIS member jurisdictions. Unlike the statutorily independent regulatory authorities, the US Insurance Commissioners are elected by popular vote, or appointed by elected officials such as the Mayor’s or State Governor’s

⁹⁸ IAIS By Laws Article 6 (4) found at <http://www.iaisweb.org/index.cfm?pageID=45>

⁹⁹ Based on confidential interviews with a long standing member of the IAIS.

¹⁰⁰ Member States at 1 January 2005: Germany, France, Italy, the Netherlands, Belgium, Luxembourg, Denmark, Ireland, United Kingdom, Greece, Spain and Portugal. New Member States: Austria, Finland and Sweden. See the EU Gateway website http://europa.eu/abc/history/1990-1999/index_en.htm

¹⁰¹ Based on confidential interviews with a Member of the IAIS.

office¹⁰². Hence, the Insurance Commissioners are much more aware of electoral outcomes and arguably their perspectives are much more highly politicised. They are also in effect politically accountable to their private industries and in some US states, the reason is evidently clear. These insurance markets are some of the largest not just in the US, but in the world. California for instance ranks as the sixth largest insurance market behind Japan, the UK, France, Germany and Italy¹⁰³. California is then followed by New York, Florida and Texas in terms of the volume of total premiums written¹⁰⁴. As a result, the US Commissioners have a significant interest in making sure that their industries are heard.

Past allegations and incidences involving State Insurance Commissioners accepting large campaign contributions from regulated insurance firms have also further tarnished the perceived independence of these US Member jurisdictions. For example, according to a review by the non-profit, non-partisan Foundation for Taxpayer and Consumer Rights (FTCR), Louisiana Insurance Commissioner J. Robert Wooley received over \$577,000 in campaign contributions from the insurance industry between 2003 and 2004¹⁰⁵. In 2003 the Oklahoma House by a vote of 95-0 voted to impeach Oklahoma Insurance Commissioner Carroll Fisher on the basis of corruption, neglect of duty and incompetence including “improperly solicited

¹⁰² This does not imply that statutorily independent authorities are not susceptible to political pressures. It is only to emphasise the fact that statutorily independent authorities are not elected by popular vote and hence are not susceptible to electoral pressures or electoral cycles.

¹⁰³ Based on direct premiums written in US\$ million. These figures were derived from confidential documents given to IAIS Members based on Swiss Re December 2006 figures, however similar reports and statistical information can be found at the Swiss Re website. For example, refer Swiss Re publication ‘World insurance in 2006: Premiums came back to “life”’ found at http://www.swissre.com/pws/research/%20publications/sigma%20ins.%20research/world_insurance_in_2006_premiums_came_back_to_life.html

¹⁰⁴ Ibid

¹⁰⁵ Article found at

http://www.democraticunderground.com/discuss/duboard.php?az=view_all&address=132x2096828

monies for a charity he established from entities he regulates”¹⁰⁶. In 2006 Mississippi Insurance Commissioner George Dale raised approximately 40 percent of his campaign funds from insurers and others with ties to the industry according to a report filed with the Secretary of State's office. Mississippi's campaign finance and ethics laws do not prohibit insurance commissioners from accepting contributions from insurers or trade groups¹⁰⁷. In 2007 Florida Insurance Commissioner stated “I agree being involved in an effort to advance a personal or political cause may be misperceived and problematic regardless of its legality”. The Commissioner drew scrutiny because he raised hundreds of thousands of dollars by soliciting donations from the insurance industry¹⁰⁸. There were allegations made that California Insurance Commissioner John Oxendine received more than \$1 million in campaign contributions from small-loan and insurance interests¹⁰⁹.

It was no surprise therefore that a number of IAIS Members interviewed¹¹⁰ admitted that US member jurisdictions are seen by other members of the IAIS to be much more “beholden” (read captured) by their private market constituents¹¹¹. It was therefore largely at the behest of US pressure that the idea of private market participation came to fruition. However the fact that it took almost 5 years for private Observership to be

¹⁰⁶ Senate Journal, First Extraordinary Session of the Forty-ninth Legislature of the State of Oklahoma Second Legislative Day, Tuesday, September 14, 2004 found at http://www.oksenate.gov/publications/senate_journals/sj2004/sj20040914x.pdf

¹⁰⁷ At least \$53,800 of the \$133,350 that Dale raised in 2006 was donated by insurance companies, their political action committees or individuals who say they work in the industry, according to a report that Dale's campaign filed Tuesday with the Secretary of State's office. Found at, <http://www.insurancejournal.com/news/southeast/2007/02/02/76517.htm>

¹⁰⁸ Found at http://www.sptimes.com/2007/04/21/State/Insurance_commissione.shtml

¹⁰⁹ Found at http://www.onlineathens.com/stories/121599/opi_1215990038.shtml

¹¹⁰ All references to interviewed Members of the IAIS refer to one or more of the 15 Members interviewed for this study; in this instance these Members were not from US jurisdictions.

¹¹¹ Based on confidential interview with a Member of the IAIS

instated¹¹² lends weight to the argument that the introduction of Observer members was not due so much to US pressure (because if this was the case they would have been instated from the beginning) but rather, the recognition by other IAIS members that they needed the resources that private actors could bring; that is, a private funding source could bolster the disproportionate and unstable funding base of the organisation¹¹³.

It is known throughout the IAIS that the EU member jurisdictions vehemently objected to having private Observers take part in what was considered an exclusive public regulatory domain¹¹⁴. The ‘openness and transparency’ argument of what is largely a US approach to insurance regulation was not something that the EU member jurisdictions were used to or necessarily advocated. Their different approaches to market interaction were the key stumbling block for having the introduction of Observers approved earlier; the even-handed voting rights proved to be very effective in blocking the US’s push to include private actors. One Member of the IAIS argued that Observers would have actually been included right from the start had it not been for EU opposition¹¹⁵. However the EU jurisdictions, as well as most other active participants (such as Australia and Canada) knew all too well that the funding base of the organisation was not only disproportionate but also relatively weak¹¹⁶. Even though a large amount of funding was

¹¹² IAIS was established in 1994 and states that “since 1999, the IAIS has welcomed insurance professionals as Observers.” Refer to IAIS website <http://www.iaisweb.org/index.cfm?pageID=28>

¹¹³ This was confirmed by a senior official at the IAIS during confidential interviews undertaken in the 2006 who is familiar with the administrative history of the organisation. The comment made in interview was that Observers were also introduced because the IAIS was able to obtain observer fee and this was important because the financial backing and resources of the organisation were weak. This comment was also substantiated by a number of other comments made by other members of the IAIS interviewed.

¹¹⁴ Confirmed in a series of interviews conducted with Members of the IAIS

¹¹⁵ Based on confidential interviews with a Member of the IAIS

¹¹⁶ This was confirmed in interviews with different Members of the IAIS from different jurisdictions.

coming from the US, it was still insufficient to fund the activities of the organisation. Thus, based on information and inferences made from a number of different Members of the IAIS, it became apparent to the author that it was ultimately the financial reality that Observers would bring a significant injection of funds through membership fees that finally brought the EU jurisdictions on board.

What they didn't envisage however was the flood gate effect of opening up membership to private Observers. Initially, only a handful of large insurance associations and firms from the US and the EU had joined the organisation¹¹⁷. However other market participants became aware of the comparative advantage these firms were receiving as a result of being part of the organisations and eventually joined as well. As a result there are currently 135 Observers listed on the IAIS website¹¹⁸. The controversial nature of accepting funds from private actors was not however taken on lightly. Unlike the fee criteria for Members of the IAIS, which is now based on a matrix of factors that take in to account the size of the jurisdiction's insurance market and the relative Gross Domestic Product (GDP) per capita wealth of that jurisdiction, Observer member fees are flat.

In addition, there were also conditions placed on the acceptance of Observer fees. Firstly, Observer fees were not to form the majority of the organisation's funding base. It was confirmed in confidential interviews that indeed Observer fees were less than 50 percent of IAIS funding¹¹⁹. Secondly, Observer fees were to be specifically earmarked towards education and

¹¹⁷ Based on the recollections of one long standing Member, these were mainly the industry associations from the US and the EU

¹¹⁸ At January 2009 <http://www.iaisweb.org/index.cfm?pageID=417>

¹¹⁹ Based on confidential interviews with Members of the IAIS; the author can confirm that they are less than 50% however the fees do still make up a sizeable portion of the total funds.

training initiatives for the less developed members of the IAIS. The fees were not, in other words, to be used for standard-setting activities or initiatives in any regard¹²⁰. Though as one Member noted, “money is fungible and I don’t know in reality if that has happened”¹²¹.

Material resources via Observer funding has therefore fulfilled a high demand from IAIS regulators. Even though Observer fees do not make up the majority of the IAIS’s funding base, they do constitute a significant portion of the IAIS’s overall funding¹²². It should however be emphasised that this is not the only form of private resource the IAIS has used. It has also extensively called for and used the technical resources of private Observers, where Observer members are asked to provide technical papers, analysis and presentations on given topics. Observer technical input was crucial to the IAIS at a time when it was not only lacking in resources to develop the quantity of standards needed but also at the pace in which the IAIS standards needed to be developed in order to justify the organisation’s viability.

This demand from regulators therefore paved the way for the IAIS Members to facilitate capture, through primarily procedural and participatory concessions. The following section uses the example of how as a result of these concessions private industry Observers have managed to use their foothold into the IAIS in order to influence the scope and content of the IAIS Common Structure for the Assessment of Insurer Solvency (also referred to more generally in this chapter as the IAIS Solvency framework)¹²³.

¹²⁰ Based on confidential interviews with Members of the IAIS; these conditions are also listed in confidential Observer member terms and conditions.

¹²¹ Based on confidential interviews with a member of the IAIS

¹²² The exact figures can not be stated for confidentiality reasons.

¹²³ IAIS (2007), Common structure paper for assessment of insurer solvency, February, found at <http://www.iaisweb.org/index.cfm?pageID=37>

Enhancing capture through procedural and participatory practices: private Observer access and influence over Insurer Solvency

Due to pressure from both the US and pressure arising from funding issues, the IAIS (or largely the EU as well as other non-US member jurisdictions) finally agreed to the introduction of private Observers to the IAIS. As a result, private Observers have been granted important privileges and concessions in return for their Observer fee contributions. Whilst Observers are said to have brought with them invaluable technical input as well as being an important sounding board for the standards that the IAIS were developing, the IAIS also recognised that Observers should also be given more direct concessions in return for their membership fees. Such concessions included the right to be involved in the official consultation process, receive IAIS papers and have access to the Observer area of the IAIS website. However, perhaps the greatest concession granted to private Observers was not simply an opportunity to provide comments during the consultation phases of standards initiatives but more importantly, their direct access to meetings, seminars and conferences; that is, decision forums and to decision makers.

The importance of this concession relative to the amount of funding provided can not be underestimated. To put such a concession in to perspective, one only needs to look at the current membership fee for Observers which in 2009 was only CHF12,500 (Swiss francs) per year (or US\$12,414 at the equivalent market rates¹²⁴). This fee for the likes of the largest Group of Ten (G-10) insurance and reinsurance firms and even some of the smaller non-G-10 insurance firms and associations is to put in simple

¹²⁴ <http://www.iaisweb.org/index.cfm?pageID=303>; USD1 = CHF 0.9931 at November 2009 from Bloomberg <http://www.bloomberg.com.au/markets/currencies/fxc.html>

terms, miniscule. In fact in some cases, it is cheaper than what some senior executives would pay for one return airfare to Basel. Thus, most private lobby groups would agree that the opportunity to hear developments directly and have access to decision makers is significantly more valuable relative to the amount of material resources contributed. Furthermore, to have direct access to an international forum where numerous decision makers from around the world are all centrally located for the duration of the standard-setting proceedings would be considered by private lobbyists to be invaluable.

Indeed, it was not unusual to see private Observers already strategically located by the coffee tables during mid-session breaks¹²⁵. It was well-known by most IAIS Members that coffee breaks and lunch sessions were some of the most crucial opportunities for private Observers to access all decision makers in the one spot. Private Observers would without hesitation use these opportunities to air their views and or grievances in a more informal setting and conversations would generally focus on contentious issues. The Chairpersons of each of the sub-committees or Committees would also be strategically targeted, as influencing the decision sway of the Chair could play a crucial role in determining decision outcomes. Interestingly however, private Observers from specific 'regions' would more often than not try and target Chairs and Members of Committees who were also from their 'region'. Euro-based private lobby groups for instance would be seen in conversation with Members from those same EU jurisdictions. Likewise, Anglo-American Observers would similarly target Chairs and

¹²⁵ This is based on the author's own observations when attending one of the IAIS's annual meetings in Basel. The author attended meetings for several different sub-committees over a period of four consecutive days in 2006.

Members who were from English-speaking Anglo-American regions¹²⁶. When this observation was posed to one Member of the IAIS, the response was that this was not so much ‘domestic’ lobbying happening on the international doorstep but rather commonality of ‘language’¹²⁷.

Private Observers of course also have access to IAIS meetings and conferences which deal directly with standard-setting drafting issues. This is very different to the BCBS for instance, which closes the drafting stages of standard-setting to all parties, including other non-BCBS regulators and private actors. The procedural mechanisms of undertaking deliberation with private actors throughout policy development process and increasing the frequency of meetings with regulators were proposed in this study as key practices used by regulators to facilitate capture. Whilst it is important to note that Observers are not formal members and as such have no right to vote on issues, Observers have been granted important concessions in terms of the scope of their participation and the opportunities they have for technical input. According to the IAIS, they are given an opportunity to comment at each stage of any consultation process¹²⁸ including drafting stages that are debated and discussed in meetings. Within these meetings, Observers are able to convey their views and even raise their objections to issues which are discussed by Members.

Their physical presence is also said to have influenced the behaviour of Members within meetings. For instance, one anecdotal example given by two non-US IAIS Members interviewed was that some of the US Commissioners

¹²⁶ Including jurisdictions such as Australia and Canada

¹²⁷ Based on confidential interviews with a Member of the IAIS

¹²⁸ Based on interviews and confidential policy documents obtained from the IAIS. The author has had special privileges obtaining confidential internal documents from the IAIS and hence specific details of these documents can not be cited.

would convey different opinions in meetings where US industry were present, as opposed to their views when they were not. Specifically, one interviewee argued that even though some of the US Commissioners agreed with the views of other Members outside the meeting room walls, they would return back to the meeting where their Observer constituents would be present and convey a view that was contrary to the one agreed upon with Members and favourable to the interests of those Observer constituents. That Member argued ‘I know that person well and I know that person doesn’t think like that; and it’s obvious that person is aware of which Observers are in there and therefore has to change their stance on issues’¹²⁹. Again, this was seen to be the result primarily of their electoral pressures domestically as opposed to other regulatory Members who did not have the same political prerogatives.

However, it was also argued by a US Member that certain non-US Members were certainly no better when it came to the issue of domestic capture. Unlike the more ‘open’ displays of industry favouritism alleged to be the case for some US member jurisdictions, the Europeans were said to be more ‘covert’ in their domestic favouritism. A specific example given was when the US and European Members came to a head over an incident where the European Members had told the US Members not to share information on a particular issue being debated internally by Members. The US Members finally agreed after much debate. However, the US Member then received a leaked copy of the confidential document from a European industry Observer that one of the European Members had given to their industry covertly. The reaction from the Member was “so we waved this around saying ‘c’mon you

¹²⁹ Based on confidential interviews with a Member of the IAIS

are blaming us for wanting an open process and transparency but then you go ahead and share/leak this info in secret!’¹³⁰

One of the most prominent examples of the IAIS regulators facilitating private capture over standards outcomes was the special treatment given to one private Observer, the International Actuarial Association (IAA). The IAA is a worldwide association of professional actuarial associations and individual actuaries, and was constituted as a formal organisation in 1998¹³¹. Actuaries are considered an important stakeholder in the IAIS process because in its words, “it uses mathematical and statistical techniques to solve problems relating to the evaluation and management of risk, especially in relation to financial instruments and the management of financial institutions such as insurance companies, pension and benefit plans, provident funds or social insurance programs. Actuarial roles may include the design and pricing of products; assessing the adequacy or the fairness of benefits; establishing provisions; assessing and managing risks; making recommendations on financing strategy, solvency and investments; providing dynamic financial analyses and financial reporting.”¹³²

For these reasons, the IAA was often asked to present on matters not only in open forums but more noticeably in partially open meetings where the IAA was the only private Observer in attendance. For instance, the IAIS would also often request the IAA to develop technical papers on various

¹³⁰ Ibid.

¹³¹ At 1 June 2003, the IAA had 50 Full Member and 24 Associate Member Associations in about 70 countries, which cover some 35,000 individuals who are full members of their association and work in around 90 countries. Refer website

<http://www.actuaries.org/index.cfm?LANG=EN&DSP=ABOUT&ACT=INDEX>

¹³² Refer website http://www.actuaries.org/ABOUT/Brochures/IAA_Brochure_EN.pdf

aspects of particular standards¹³³. In ‘closed’ regulator meetings the IAIS would note that the IAA was in the process of developing their own positions for their own members on similar issues and that the IAIS should in effect ‘piggyback’ on these papers¹³⁴. Indeed one Member of the IAIS did in fact confirm that the IAA had a somewhat ‘special’ status among private Observers primarily because of its superior technical proficiency and specialisation in actuarial matters¹³⁵.

The IAA was in fact the only private Observer involved in the early stages of developing what is now known as the IAIS Common Structure for the Assessment of Insurer Solvency (also referred to in this chapter as the Solvency framework) (IAIS 2007). This Solvency framework was released in February 2007 and was the culmination of work undertaken formally by the IAIS since 1999. It is in effect the official blueprint for the overall IAIS risk based approach to the assessment of insurer solvency and informs all of the other standards and guidance that the IAIS produces. There was very close cooperation between the IAIS and IAA in the initial development of the issues contained in the Solvency framework, where the IAIS would present their initial ground work to the IAA and vice versa, the IAA would present their technical reports to the solvency subcommittee. This close cooperation culminated in the IAA forming its Insurer Solvency Assessment Working Party in 2002 with the express aim to act “in support of the IAIS” and “assist

¹³³ For example, confidential minutes reveal the IAIS sub committee requested the IAA to develop issues such as internal modelling approaches.

¹³⁴ Based on the author’s own observations in several closed meetings. These meetings took place in 2006.

¹³⁵ Based on confidential interviews with a member of the IAIS

in the development of a global framework for insurer solvency assessment and the determination of insurer capital requirements”¹³⁶.

The IAA has had a very privileged relationship with the IAIS whereby the IAA would be invited by the IAIS solvency sub-committee to present its work on solvency issues. Specifically, the IAA’s report, ‘A Global Framework for Insurer Solvency Assessment, A Report by the Insurer Solvency Assessment Working Party’ which was finalised in 2004 was the result of the direct request of the IAIS solvency subcommittee for the IAA to undertake work on solvency issues (IAA 2004). The IAA also note that “As part of the response of the International Actuarial Association (IAA) to the International Association of Insurance Supervisors (IAIS) paper “On Solvency, Solvency Assessments and Actuarial Issues - An IAIS Issues Paper”, the IAA offered to support the IAIS in developing a solvency framework, consistent with the proposals for a new international accounting standard. In partial fulfilment of that offer, the IAA is pleased to contribute a report from an IAA Solvency Working Party for your consideration”¹³⁷. In fact, work undertaken by the IAIS Solvency sub-committee was often put on hold in anticipation that the IAA Solvency Working Group would be producing work for the IAIS’ consideration. For instance when the Solvency sub-committee were planning to commence work on issues concerning internal models, the sub-committee agreed that it would ‘make sense’ to see what the IAA produced on this topic before commencing its own work¹³⁸.

¹³⁶ IAA, Report of the IAA’s Working Party on Solvency, found at <http://www.actuaries.org/index.cfm?lang=EN&DSP=PUBLICATIONS&ACT=PAPERS>

¹³⁷ Ibid.

¹³⁸ Based on confidential minutes from 2005 records

Whilst the IAIS admit that the work undertaken by the IAA would be useful in the Solvency sub-committee's task of setting a framework and would be used as background material in the development of capital adequacy requirements, key aspects of the IAA's work has evidently been taken into account in the finalised Solvency framework. Elements incorporated into the framework include a number of the guiding principles advocated by the IAA for the IAIS to use in the overall design of the paper including a 'three pillar approach' to supervision, principles versus rules based approach, a 'total balance sheet approach', appropriate time horizons, types of risks to be included, the more importantly standardised and advanced approach methodologies and risk management and governance (IAIS 2007). The Solvency framework also refers to the three 'levels' within the overall framework, which take into account the three pillars approach of minimum capital requirements, supervisory assessment and market disclosures. The framework also outlines its principles based approach and incorporates the total balance sheet approach, types of risks, appropriate time horizons, and the standardised and advanced approaches including internal models. In fact, the Solvency framework gives explicit credit to the IAA in its introductory section, acknowledging the "ongoing support and input from the IAA" (IAIS 2007: 11) (refer Table 5.1 for overview).

It is evident that the presence of the IAA as a private Observer at decision forums provides them with the opportunity to influence decisions (and arguably some like the IAA are even asked to provide their technical input into the standard setting process). However, this relationship as well as outcomes including the Solvency framework has also been highly influenced

by institutionalised boundaries created by the IAIS organisation itself. This includes the way in which the organisational structure of the IAIS has intentionally ‘positioned’ private Observers (including the IAA) in the overall standard-setting process, as well as the way in which the organisation has generated its own internal norms about the identities of certain actors and their associated legitimacy. The remainder of this chapter argues that, in the case of the IAIS, we see a deliberate ‘included exclusion’ of private Observers such that their access to decision forums is conditional and more often than not restricted by these institutionalised constraints. As a result, this influence has to a large extent been fundamentally constrained by institutionalised barriers which led the Solvency framework to resemble other existing capital standards such as Solvency II in the EU, rather than reflect the interests of the Observer insurance community.

5.2 High demand, high threat: constraining capture through the ‘included exclusion’ of private Observers

Constraining capture: the inner and outer circles of the IAIS Committee structure and the case of the Solvency framework

Participation in the IAIS standard-setting process has been an important concession granted to private industry in return for their monetary contributions and, in the case of the IAA, their technical resources as well. However, private participation in policy forums can be intentionally ‘positioned’ so that whilst private actors *feel* as though they are getting some pay off for their resources, ultimately they are excluded from the decision making process. In the case of the IAIS, whilst pressure from the US led to the inclusion of private actors in decision making forums, counter pressure

from the EU member countries ultimately led to the ‘included exclusion’ of those Observers such that their participation was ‘structured’ to ensure ultimate decision and influence over outcomes resided with Members. This means that private participation in standard-setting meetings has been conditional and in some instances, completely closed to private Observers.

Access to decision making forums and decision makers is an important condition for private actors to influence decisions and outcomes. As discussed, the IAA has had important influence over the work of the IAIS solvency subcommittee as one example, but what about other Observers? Access to and participation in decision forums is misleading to the extent that they infer both reciprocity between public and private actors and the ability for private actors to influence outcomes. Decision forums that allow private participation may not allow a free mutual exchange between public and private actors and in fact be structured so that private actors are only given limited scope and opportunity to influence decisions. Participation therefore may very well depend on how public actors permit private actors to participate.

This can be seen in the IAIS. It is no accident that Observers are not ‘Members’ of the IAIS and as such they have a very different role and status within the organisation. More importantly, this difference between Members and Observers has been reinforced institutionally, which can be illustrated by four features of the IAIS Committee structure. Firstly, whilst members may join, vote and take part in all committees, Observers can be excluded from meetings if Members deem public discussion on an issue as ‘inappropriate’¹³⁹.

¹³⁹ From confidential internal IAIS documents.

Secondly, where meetings are open, formal protocols apply such as seating arrangements and rules concerning the active input of Observers. Thirdly, the Chairs of Committees are given significant powers to determine the scope of Observer participation and the amount of consultation that is deemed appropriate for that Committee. Access rules therefore may vary across the numerous committees and sub-levels of each committee. Finally, when Observers are given access to make their contributions by way of formal presentations and or through the consultation mechanism, Observers often do not know if or how their contributions have been taken into account. Taken together, the institutional boundaries created do not allow Observers to stand on equal footing with Members and act to constrain full participation and input from private industry.

Beginning with the first of these important institutional constraints, it is neither surprising nor controversial that only regulators are allowed to be Members of committees and therefore given free reign in terms of their participation and voting rights. Even private Observers would agree that this is inevitable. What Observers do fundamentally disagree with however is the ability of Members to restrict Observer access to crucial drafting sessions and standard-setting meetings where the initial formation of ideas is undertaken¹⁴⁰. The IAIS has in fact developed an internal policy statement for Members and Observers which outlines the scope and conditions of Observer participation in IAIS activities¹⁴¹. Whilst in principle the IAIS maintains that its Members will seek to consult with and obtain the views of

¹⁴⁰ This was confirmed in interviews with several Observers from both the US and the EU

¹⁴¹ This is a confidential IAIS document and cannot be cited for this reason.

Observers at each stage of the standards development process, there are significant caveats which act to counter this principle.

One of the most important is the rule that allows Members to close access to meetings which are deemed ‘inappropriate’ for public discussion. Examples given are matters that fall under confidentiality and privacy laws or those dealings that are specific to the internal workings of the organisation. However, the rule also states quite clearly that it is not intended to be limited to the circumstances listed and hence can simply be closed because Members decide that the matter should not be publicly discussed¹⁴². One Observer stated that a reason frequently given when an issue or meeting is closed is that “this doesn’t concern you, this only concerns regulators” which was argued by the Observer as being ‘demonstrably false’ and defeating the purpose of having Observer input in the first place¹⁴³. Even one Member confidentially admitted that “it is reasonable to say that it’s not clear why some of the sub-committees are closed, because what is discussed in that meeting is not that confidential...”¹⁴⁴

What is more interesting is the case of the ‘partially open’ meeting. At first glance, a partially open meeting to an Observer would be more preferable than no participation at all. However, ‘participation’ is again structurally conditioned to allow only Observers to join meetings before or after Members have conferred with each other in private. Far from allowing Observers to take part in mutual discussions with regulators, Observers are often invited to make their verbal contributions in the time slot allowed and

¹⁴² Ibid

¹⁴³ Based on confidential interview with an IAIS Observer

¹⁴⁴ Based on confidential interview with a Member of the IAIS

then asked to leave¹⁴⁵. As one Member noted, “[in these cases] they just hope that their comments will be taken into account but they have no way of knowing if their comments have done anything or not...”¹⁴⁶ Regulators will then close their doors and conduct private discussions based on what was presented and Observers will indeed have no way of knowing if their ‘contribution’ actually mattered until drafts are released at the very later stages of formal consultation. As one Observer argued “we have run up against circumstances where our input has been systematically ignored, *even though it has been solicited, and as a process theoretically supposed to provide*”¹⁴⁷.

The reason both Chairs and Committee Members might come to the conclusion that meetings should be closed or partially open is said to result from the concern that regulators may not be able to engage in frank discussions with the knowledge that industry Observers are also there taking note of every word said¹⁴⁸. From the author’s observations, certain Observers attended meetings not to make their view known so much as to take down detailed notes of what was being discussed in order to disseminate these discussions to their industry participants¹⁴⁹. The other reason is said also to stem from the concern that regulators may not want Observers in meetings because in some cases regulators have been criticised by their respective industry Observer for not taking a particular line that would be favourable to their ‘national’ interests¹⁵⁰. Therefore there is recognition by regulators that

¹⁴⁵ This was both observed by the author and also confirmed by a number of interviewees

¹⁴⁶ Based on confidential interview with a Member of the IAIS

¹⁴⁷ Based on confidential interview with an IAIS Observer

¹⁴⁸ Based on confidential interview with a Member of the IAIS

¹⁴⁹ From meetings attended by the author in February 2006

¹⁵⁰ Ibid

sometimes Observers might not necessarily contribute to the 'regulatory' prerogative, but instead act to push their vested interests which is argued to be unwelcome in a regulator's domain¹⁵¹.

On the other hand, many meetings are also open to Observers and their input is actively sourced. Within these meetings Observers can take part in all parts of the discussion and actually 'observe' all the debates first hand. However, these meetings again are not 'open' in a sense of 'unstructured'. Yet another crucial structuring of Observer participation is the formal rule that in order to further maintain the institutional distinction between Members and Observers, Observers must be seated separately in meetings¹⁵². The internal policy statements even indicate the type of seating arrangements that are best, generally following the rule that Members are to sit within the inner or main table of the meeting and that Observers must sit behind the Members in the outside circle or chairs¹⁵³. It is evidently difficult to engage in discussions with Members if you are not included as part of those discussions and almost 'relegated' to the back of the room. This seating arrangement rule however was not always in place and was only introduced recently because "[certain] members were squeamish about sitting with Observers...Members wanted more formal protocol for their authority". Moreover, Members wanted the formal separation of seating in order to "always reinforce the notion that no matter what...the ultimate decision always resides with regulatory Members"¹⁵⁴. It was soon evidently clear in discussions that "generally

¹⁵¹ Ibid

¹⁵² This was also directly observed by the author

¹⁵³ Based on confidential internal policy documents of the IAIS

¹⁵⁴ Based on confidential interview with a Member of the IAIS

speaking, European Members were the ones most opposed to open seating”¹⁵⁵.

Furthermore, to make matters more difficult for Observers, Observers are not actually allowed to make any unsolicited contributions to any of the discussions generated by and among Members. Instead, Observers are only allowed to make comments when the Chair formally asks them to do so¹⁵⁶. Whilst in theory Chairs would try and do this at regular intervals of the meeting, Chairs are sometimes too preoccupied with balancing the dynamics of their Members and facilitating agreement between them to realise that Observers are also there waiting to make their views known. Based on the author’s own observations, Chairs would more often than not only solicit the views of Observers *after* Members have already engaged in lengthy and somewhat heated debates over issues and had come to some form of consensus. The Chair would then solicit comments from Observers who, by this stage, would have limited means of objecting or contributing given that Members have already come to some agreement on the matter¹⁵⁷.

Observers therefore are given fairly uneven and sometimes restrictive access to drafting sessions and decision making meetings. Their input in to these meetings can as a result be minimal, which means that Observers often must then resort to making more formal written comments in the consultation periods offered for each draft standard. Even though IAIS protocols stipulate that Observers’ views should be gathered at each stage of the standards development process, Committees are only required to

¹⁵⁵ Ibid

¹⁵⁶ From confidential internal policy documents of IAIS

¹⁵⁷ Based on observations made by the author who attended meetings in 2006

undertake at least one round of formal consultation prior to the adoption of standards. This means that if meetings have been closed, partially open or 'open' in a restricted sense, Observers are often left with access to only one window of opportunity to make their views known which is open for either 30 or 60 days¹⁵⁸.

However, these formal consultations only occur at the very last stages of drafting which means that by that stage, Members have invested a significant amount of time deliberating over the fundamental structure and principles of the standard, leaving little room for Observers to change the 'big picture'. As one Member confidentially noted, "the amount of change that takes place in the papers in the very final round of consultation which is the one Observers then participate in is pretty small..."¹⁵⁹ This was because the most important stages of deliberation usually occur in the drafting and decision meetings where "the committee considers every single aspect of each standard [and] things do get considered for a reasonable length of time"¹⁶⁰. One Observer also agreed, arguing that even though they have been able to get changes through, they were the "less important changes" and that most importantly, "it shouldn't be that [members] have already bought in to something before you have the opportunity to comment"¹⁶¹. The greatest concern for this Observer was that "if the comment process only starts at the 11th hour after everyone has worked on these things then what does it really mean in practice? It's great to have a comment period and all, but not so

¹⁵⁸ Confirmed in interviews with several IAIS Members

¹⁵⁹ Confidential interview with a Member of the IAIS

¹⁶⁰ Ibid

¹⁶¹ Confidential interview with an IAIS Observer

great if already psychologically people have bought into things. That's why open meetings are so important"¹⁶².

Private Observer access to standard-setting meetings and to decision makers is certainly not as unfettered and lucrative as Observers would hope for. The result of closed, partially open and 'structured' open meetings as well as Chairmanship discretions is that access rules are very different from committee to committee. This is reflected for example in a scheduled list of meetings held by the IAIS¹⁶³; out of 27 meetings that had been scheduled across numerous different committees, sub-committees and working parties, 13 had been deemed 'not open' or 'partially open'¹⁶⁴. The ramification for Observers if a meeting is deemed closed or even partially open, is the recognition by one Member that "it's difficult then obviously for Observers to provide their contributions in these [formative discussions] because there is nothing for them to observe..."¹⁶⁵

Furthermore, the compositional membership structure of committees, the total number of committees across various standard-setting issues and their numerous sub-working group layers make it very difficult for Observers to exert their influence consistently. The IAIS has four overarching Committees and then another 15 sub-committees across a number of different issue areas. In addition to this it also has another two task force groups to review IAIS work (refer Figure 5.1). Some have even argued that it is because of the IAIS organisational structure where "no-one [can] exert

¹⁶² Ibid

¹⁶³ The scheduled meetings were from 2006-2009

¹⁶⁴ Based on confidential internal documents of the IAIS; there could potentially be more closed and partially open meetings than this figure because some of these meetings are annual meetings where a number of meetings take place simultaneously.

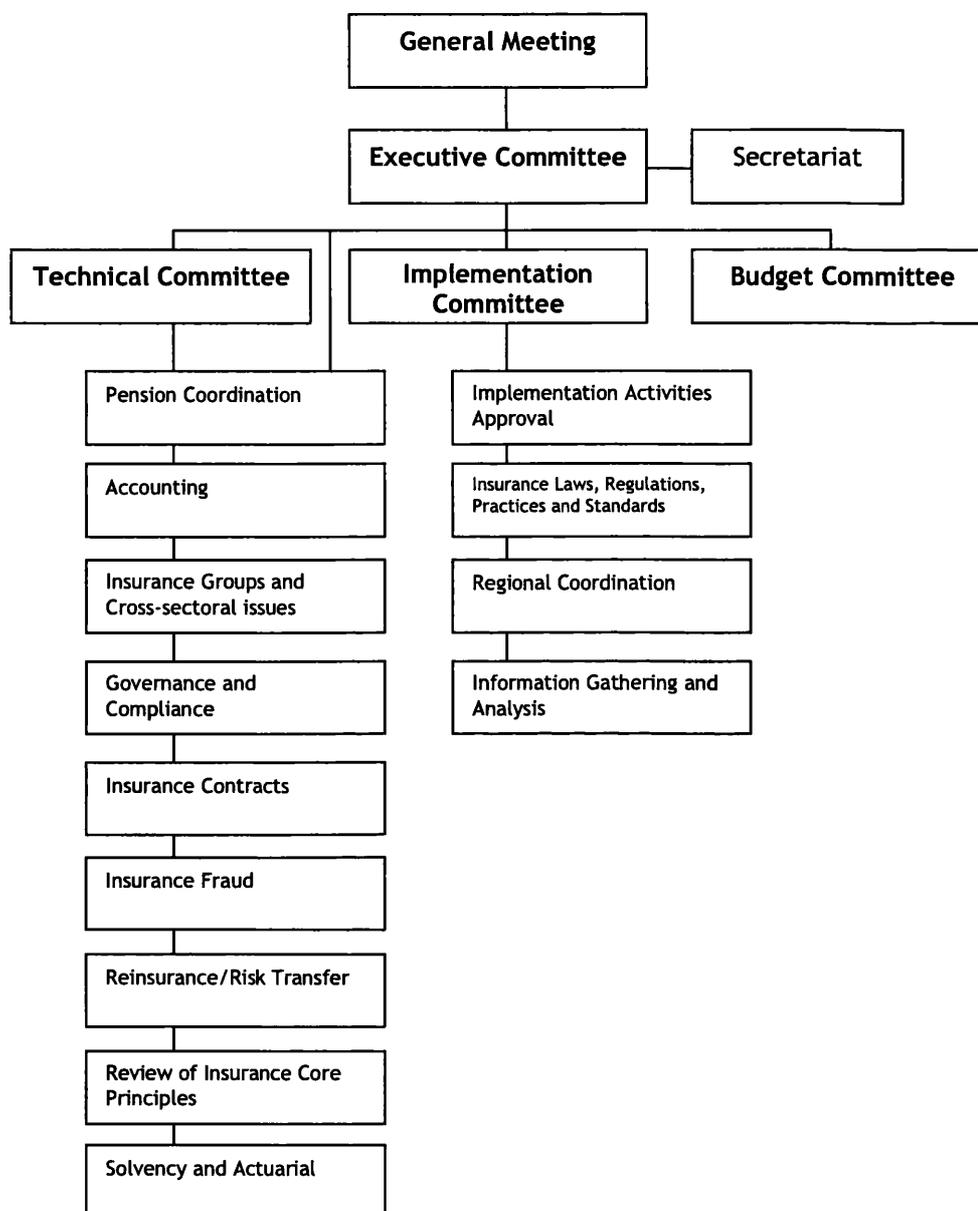
¹⁶⁵ Ibid

over-proportionate influence...because so many people get a say” that standards can not be developed quickly enough let alone implemented¹⁶⁶. Thus the committee structure prevents the domination of any one jurisdiction, which is argued to be necessary sometimes in order to “get things done”¹⁶⁷. The fact that the solvency work took over 7 years to complete is also testament to the structural impediments associated with committee processes and decision consensus.

¹⁶⁶ These comments came from a Member and from other international organisations

¹⁶⁷ Ibid

Figure 5.1 IAIS Organisation Chart



This study proposed that by limiting or structuring private participation, or undertaking limited deliberation with private actors in the latter stages of the policy development process, regulators could significantly constrain capture. The effect of these institutionalised constraints can be clearly seen in the case of the work undertaken by the Solvency subcommittee. Specifically, these constraints had a significant affect on the

way in which privileged Observers such as the IAA could influence outcomes. For example, whilst work on issues related to solvency began in 1999, the solvency subcommittee meetings were not opened to Observers until June 2005. It was evident from confidential minutes that from 2002 Observers wanted more input into such an important issue area, with the Solvency subcommittee consequently acknowledging that it would need to give Observers more of an opportunity to provide comments on certain papers and to make the activity of the subcommittee more “transparent”¹⁶⁸. As a result the subcommittee agreed to make past minutes of meetings available to Observers via their access to the website, but participation in meetings was still not opened. More importantly, access to past minutes was also significantly qualified by the Chair’s request for Members to review the past minutes to see if there was “anything sensitive they would wish to delete”¹⁶⁹.

As discussed earlier in this chapter, the IAA was one of the only Observers invited to attend these closed Solvency meetings. However these invitations were for the IAA to present its technical reports and material for specific agenda items only and were not general invitations to join the discussions that took place within the subcommittee¹⁷⁰. Details of records show that the IAA would only be there for the time slot allocated for their presentation and the remainder of the meeting would then be for Members to discuss what had been presented to them. However the real impact that this structured interaction with the IAA and more generally Observer exclusion had was that from 1999 to 2005 the important groundwork for developing the Solvency framework was heavily influenced by its Members. Specifically,

¹⁶⁸ Based on confidential IAIS Solvency sub-committee minutes of meetings from 2002

¹⁶⁹ Ibid

¹⁷⁰ Ibid

an important process that was occurring simultaneously during this period was the EU's reform of Solvency I which was the original set of solvency margin requirements that had been in place since the 1970s¹⁷¹. This coinciding process meant that Members from the EU had a vital interest in ensuring that the IAIS principles were consistent with the reform direction that the Solvency II project¹⁷² was taking. For instance, when the Solvency II project was officially launched in 2002, the draft report of the preliminary principles was sent to the IAIS and emphasis was placed on the need to have consistency with the IAIS work and more importantly "convergence of insurance solvency standards"¹⁷³.

Members from the EU were also reporting back to the subcommittee on the changes in their respective solvency regimes as a result of the Solvency II proposals. Whilst there was significant discussion around whether the IAIS framework should adopt the 'three pillars' approach being proposed by Solvency II, it is apparent from confidential records that because the Members from the EU were heading in that direction under the Solvency II banner that the IAIS had little choice but to follow. In July 2004, the European Commission (EC) had published the "Framework for Consultation" which set out the core policy guidelines and principles that the new Solvency II regime would incorporate. By this stage all of the main principles outlined in the EC's Framework paper were being discussed for the IAIS Solvency framework, including the detailed guidelines around the very important issue

¹⁷¹ Refer to the EU website

http://ec.europa.eu/internal_market/insurance/solvency/background_en.htm#july2007

¹⁷² It became clear during the Solvency I process that a more fundamental and wider ranging review of the overall financial position of an insurance undertaking was required, looking at the overall financial position of an insurance undertaking and taking into account current developments in insurance, risk management, finance techniques, international financial reporting and prudential standards. This project became known as Solvency II.

¹⁷³ Based on confidential IAIS Solvency sub-committee minutes of meetings from 2002

of technical provisions¹⁷⁴. After extensive deliberation, the EC had almost finalised its directive by 2005, and following completion of the consultation process, the Commission adopted the Solvency II Proposal in July 2007¹⁷⁵.

The timing of this process is significant because by the time the IAIS had essentially 'bought-in' to the same underlying principles as Solvency II in 2005, the solvency subcommittee had at that point opened the meetings to Observers. However not only had a lot of the groundwork been undertaken by Members, this Observer participation was then only partially opened to parts of the meetings and furthermore was determined by the Chair when drafting the agenda. In the meetings opened since 2005, Observers have only been able to attend for one agenda item only, where Observers would be invited to present their views and comments, as opposed to engaging in active dialogue with Members. To reiterate the frustrations of one Observer from the US "it shouldn't be that [members] have already bought in to something before you have the opportunity to comment"¹⁷⁶.

Moreover, the timing of the final release of the IAIS solvency structure paper in February 2007 and the EC's release of Solvency II in July 2007 is not coincidental. According to a long standing solvency subcommittee member, the subcommittee was adamant that it had to release its paper before the EC published Solvency II so that it didn't look like the IAIS was 'piggybacking' on the EC's work¹⁷⁷. Regardless of the perceptions, the two frameworks contain fundamentally the same structure based on the 'three

¹⁷⁴ The guidelines and principles on technical provisions are for the most part also contained in the IAIS solvency structure framework

¹⁷⁵ Refer to EU website

http://ec.europa.eu/internal_market/insurance/solvency/background_en.htm#july2007

¹⁷⁶ Based on confidential interview with an IAIS Observer

¹⁷⁷ Based on confidential interview with a Member of the IAIS

pillars' approach¹⁷⁸ and the same underlying principles (refer Table 5.1 for comparisons). This was according to one long standing Solvency subcommittee Member "inevitable" given the emphasis on the need to have harmonised principles and standards across global regimes¹⁷⁹. Thus, as the Solvency case shows, private participation in the IAIS is not free and unfettered but in fact structured so that private Observers are only given limited scope and opportunity to influence outcomes. Observers are therefore not given the consistent opportunity or means to exert their influence over outcomes in the various stages of the standards development process, exemplifying the procedural and structural constraints designed to capitalise on private capabilities as well as at the same time ensuring that regulators are able to exert their authority over outcomes.

¹⁷⁸ Three pillars of supervisory assessment, minimum capital and public disclosure

¹⁷⁹ Based on confidential interview with a Member of the IAIS

Table 5.2 Comparison of Solvency regimes

IAIS SOLVENCY FRAMEWORK	EU SOLVENCY II	IAA GLOBAL SOLVENCY
FRAMEWORK LEVEL 1 - SUPERVISOR MUST HAVE ADEQUATE POWERS	SUPERVISORY POWERS – ARTICLE 34	
FRAMEWORK LEVEL 2 – REGULATORY REQUIREMENTS	QUANTITATIVE REQUIREMENTS	CAPITAL REQUIREMENTS /SOLVENCY ASSESSMENT
A robust and risk sensitive solvency regime	General principles of supervision – Article 28	
Financial requirements appropriate to the type of risk	Own Risk and Solvency Assessment – Article 44	
Risk characteristics and components		Key components of risk and types of risk
Total balance sheet approach		Total Balance sheet approach
Valuation and market consistency	Valuation of assets and liabilities – Article 73	
Determination of current estimate	Technical provisions - best estimate Articles 75-78 and Articles 80-84	
Role of technical provisions and capital	Technical provisions – Articles 74-84	Role of capital
Underwriting risk in technical provisions and capital		Underwriting risk
Asset-liability mismatch risk in technical provisions and capital		Market risk – asset/liability mismatch risk
Time horizon for calibration of technical provisions and capital	Calibration for minimum capital	Appropriate time horizon
Capital requirements and diversification between risk factors	General provisions for Solvency Capital Requirement – Articles 100-108	Appropriate risk measures
Cost-of capital approach and percentile approach for the determination of the technical provisions	Value at Risk (VaR) measures	Risk Measures
Use of standardised and more advanced approaches, including internal models	Standard formula and Internal Models – Articles 102-124	Standardised, Advanced and Internal Models methodologies
Governance Requirements	System of Governance – Articles 41-49	Corporate Governance
Market Conduct Requirements		
FRAMEWORK LEVEL 3 - SUPERVISORY ASSESSMENT AND INTERVENTION	SUPERVISORY POWERS AND SUPERVISORY REVIEW PROCESS – ARTICLES 34 AND 36; CAPITAL ADD-ONS – ARTICLES 37	
Public disclosure and transparency	Public Disclosure – Articles 50-55	

Why the regulatory threat? EU institutional norms, US fragmentation and the perceptions of regulatory 'credibility'

One question that arises in the case of the IAIS Solvency framework is why were EU regulators able to influence the framework based on Solvency II prerogatives? More generally, why has structured participation come about? Pressure from the US led to the inclusion of private actors in decision making forums, but why was counter pressure from the EU member countries successful given that the US was highly critical of closing access to meetings?¹⁸⁰ There are two main reasons that led to the 'included exclusion' of Observers such that their participation was 'structured' and these reasons are closely tied to the nature of the European and US regulatory systems. Firstly, US Members neither agreed to the structuring of Observer participation, nor did they oppose the EU push to have more formal protocols in place. According to officials interviewed, the US Commissioners did not take an active interest in the activities of the IAIS in the early stages of the organisation's work. Their reasons were that it had nothing to do with their domestic political considerations. Devoting time to an international organisation, which in the eyes of domestic electorates, had nothing to do with their own insurance activities, was a primary reason why the US Commissioners were said to be less than interested in participating in the IAIS's work¹⁸¹.

Instead, this was left to the representative body, the NAIC, to form opinions on behalf of the US State Commissions. However, unifying the interests of vastly different US state insurance commissions (with limited

¹⁸⁰ Based on confidential interviews conducted in March 2006.

¹⁸¹ Ibid

interest in international developments in insurance regulation) was said to be logistically difficult. This logistical difficulty it seemed had more to do with the internal coordination processes between the NAIC and the US state Commissions, which weakened the US's ability to present its interests in a unified manner. According to confidential sources, despite the concerted efforts of the NAIC to alert and advise the US Commissioners on the importance of the work being undertaken by the IAIS, they were according to the official simply "not on the same page" when it came to matters outside of their state jurisdictions¹⁸². It was, according to officials, the outcome of the IAIS Solvency framework, which US Commissioners recognised was almost entirely based around the EU Solvency II project, which jolted the US Commissioners to take a much more serious interest in the work of the IAIS. They realised they had much more at stake and that the work of the IAIS would ultimately impact their domestic prerogatives¹⁸³.

It was therefore fragmentation of US interests, as well as US domestic political apathy, which in effect allowed the EU Members to dominate not only the development of IAIS standards but also, the internal norms of the organisation that were largely influenced by EU protocols. What was explained as perhaps one of the more fundamental barriers to Observer influence was the acute awareness by regulators of what can be described as peer credibility and the institutionalised distinctions made between Members and Observers. This institutionalised distinction and emphasis on the identity of 'regulators' was largely influenced by the more formal distinctions and identities generated by the European regulators. Specifically, the EU

¹⁸² Based on confidential interviews with officials in March 2006.

¹⁸³ Ibid

regulators have played a pivotal role in influencing the way the IAIS has not only developed as an organisation but also for the way the IAIS has created internal norms and identities, the most evident being the distinctions between ‘Member’ and ‘Observer’, largely as a result of the fact that EU regulators felt their authority to be compromised with private industry participation in what was considered a ‘regulatory’ policy domain.

There was for instance an evident distinction between the ‘European’ and ‘Anglo-American’ regulatory identities amongst the more dominant IAIS Members¹⁸⁴. The former was referred to as much more conservative and consequently had a much greater preference for hierarchical relations with industry than the more open and transparent styles of the Anglo-American regulators. The hybrid blend of open, closed and partially open meetings in the IAIS is testament to this regulatory ‘culture clash’ between the two dominant styles. However what in principle bound these two identities together was the internal identity generated by the IAIS itself, and that is the institutionalised distinction between ‘Regulatory Member’ and ‘Private Observer’. Based on the author’s observations of meetings and numerous interviews with various Members, the identification that a Member was a regulator created an expectation of behaviour or the way in which you were supposed to construct your views and apply your decisions because of who you were. This was often then further accentuated by the fact that as the national representative at an international forum, Members appeared to be even more acutely aware of their place as a regulator amongst other

¹⁸⁴ According to the author’s own observations in meetings as well as confirmation from many IAIS members who were not from the EU or from the US.

international regulators and as a result, perhaps more conservative in their views than they would otherwise be in their domestic jurisdiction.

The identities of private Observers were also largely understood by Members by virtue of their distinction as those obviously representing private industry interests. They too were expected to behave in a certain way and Members had predefined expectations of the types of comments they would receive from those Observers based on their affiliation and industry mandate. Comments were often made in this regard, where specifically Members ‘already knew’ what Observers would say “because that’s what they’re paid to do”¹⁸⁵. The expectation of Observer behaviour went so far as Members knowing which Observers were normally the more ‘verbal’ ones in meetings and which Observers provided written comment instead¹⁸⁶. As a result, one Member explained for instance that in open meetings, Members are acutely aware and even reluctant to accept Observer contributions because they are also aware of the potential criticisms that await them from their fellow regulators¹⁸⁷.

Observers are said to be very frustrated about this at times because they are given no reason or explanation for why their contributions were not taken in to account. They are, if lucky, simply told that their contributions were “noted – no change required”¹⁸⁸. As one Member admitted, “perhaps the IAIS Observers have a legitimate concern that they are not listened to as much as they like...”¹⁸⁹ Another Member explained that whilst peer credibility is important, it also boiled down to the fact that Members simply did not

¹⁸⁵ Based on confidential interviews with a number of IAIS Members

¹⁸⁶ Ibid; also observed by the author in meetings

¹⁸⁷ Based on confidential interviews with a non-EU IAIS Member.

¹⁸⁸ Ibid;

¹⁸⁹ Based on confidential interviews with a Member of the IAIS

agree with the views of Observers. The message given to Observers is “we hear you, but we don’t *agree* with you”¹⁹⁰.

This was said to be even more acute in the case of certain Observers who were recognised by all regulatory circles as ‘known lobbyists’. In these instances, regulators were even more reluctant to take the views of these lobby groups on board simply because they knew that these representatives were being paid to push a certain vested agenda. Being seen by fellow regulators to be supportive of these lobbyists’ views would in the opinion of one Member jeopardise your own credibility and professional integrity¹⁹¹. Thus, even though Observers are invited to these open meetings where technically they are supposed to provide their input in to discussions and debates, it is very difficult for them to do this freely and of their own accord. Instead, Observers are constrained by formal protocols, which served to generate perceptions of regulatory credibility which act to impede their influence over the formation and development of standards and principles.

It was interesting that this treatment was only directed towards those who were known or perceived lobbyists. As a general rule, Chairpersons who allowed meetings to be opened to Observers must allow all Observers to attend however this didn’t always have to be the case. Chairs instead have the option to invite individuals with specific expertise, giving those Observers a very lucrative captive audience. This was indeed the case for the IAA who held a privileged position in the eyes of many IAIS Members because the IAA was viewed as objective, non-partisan, technical specialists who could be

¹⁹⁰ Ibid

¹⁹¹ Ibid

entrusted to get on with the task of providing technical input without pushing a vested agenda¹⁹².

The distinctions between Member and Observer created by the organisation in other words created the expectation that Members would behave like regulators and apply a prudential decision framework for the interests of the public and Private Observers would behave either like lobbyists and exert their industry preferences through direct and indirect pressure or in the case of the IAA could be entrusted as 'technicians'. If Members or Observers were to veer from their expected behaviour (for instance Members supported the positions of industry or private Observers opted for more stringent rules) this would be looked upon with cautious suspicion amongst others and judgements would be made about their respective 'credibility'. In the case of Members, this would translate in to reputational and professional credibility and for private Observers, this would be interpreted as self-interest disguised as 'public' interest. The problem of course with this is that Members could legitimately be raising an industry issue which could impact the greater public interest and Observers could legitimately want more stringent standards for greater industry stability.

Internal identities created as a result of these institutionalised distinctions therefore generated what can only be described as an institutionally constructed constraint in the form of 'peer pressure' on behaviour, and this was in large, very influenced by the formal protocols developed by the European regulators. There would be an unspoken pressure

¹⁹² Ibid

for regulators not to be seen to be too sympathetic to the views of industry. In the case of some Members who were viewed as being ‘too close’ to their respective industry Observers, those Members were in turn earmarked as being ‘too influenced’ and consequently regarded by other Members as being ‘known as captured’¹⁹³. Observers too had a good understanding of how they might come across to Members if they tried to push too hard for their vested interests. As one Observer stated “when commenting, I try to advocate other ways of doing things rather than just focus on the impact it would have on my industry...”¹⁹⁴ This is because this Observer knew too well that they wouldn’t have any chance of getting through to standards outcomes if they didn’t at least come across as contributing to the solution to a problem. However, this too could also backfire on Observers who would always propose the same types of solutions which to Members would translate in to solutions that would be beneficial for their industry. As one Member explained “[observer comments] are given full consideration but if they keep sending them through, it won’t do much because the Committee just decides and then moves on...”¹⁹⁵

The impact of the access rule on private instrumental influence is that it can play a significant role in structuring when and how Observers can provide their input on matters that have essentially already been decided by Member regulators. The benefit of this for regulators who have used private instrumental capabilities for their purposes is that they can simultaneously provide the concession of ‘participation’ to private actors without actually allowing them to gain any influence over ‘their domain’. The institutional

¹⁹³ Ibid

¹⁹⁴ Based on confidential interview with an IAIS Observer

¹⁹⁵ Based on confidential interview with an IAIS Member

distinction created between Members and Observers further reinforced the separation in boundaries between what is expected of a Member (as a regulator) and what is expected from an Observer (as a 'lobbyist').

Expectation of behaviour which is created by internal norms and identities therefore plays a significant role in the 'structuring' of private participation. This type of role play contributes to not only the creation of cognitive boundaries but also in the action taken to reinforce this separation through institutional protocols and access rules. This is even clearly stated in the IAIS's internal policy documents, where even the formal separation of seating arrangements is required to "facilitate the distinction between Members and Observers"¹⁹⁶. This sort of 'constructed' separation is not often factored into studies on influence, however these institutional boundaries do act to fundamentally counter the full impact of private influence on outcomes.

Thus, the question that then remains is why private Observers would continue to engage in such a structured interaction? In short, the answer was access was better than no access to decision forums and that on a 'cost-benefit' analysis, what private Observers contributed by way of resources was minimal compared to the opportunity for private actors to gain 'face time' with key decision makers. One Observer reiterated this, stating simply that "we appreciate the many opportunities we get to comment orally and to provide written comments and to participate" but there was no other

¹⁹⁶ Based on confidential internal policy documents of the IAIS

expectations of further concession other than these opportunities for ‘face time’¹⁹⁷.

5.3 Conclusion

The regulators of the IAIS used the material and technical resources of private actors to secure the viability of the organisation. In return for the resources, the IAIS granted private actors concessions by way of access to and participation in decision forums. What is important however is some Observers like the IAA had even more privileged access to influence standards outcomes such as the IAIS Solvency framework. However, regulatory Members, particularly from the EU, also used institutional constraints, such as access rules and formal protocols to ‘structure’ the participation of private actors so that they would have restricted opportunities to influence outcomes. This not only prevented Observers from directly influencing decisions, but more importantly, allowed European regulators to shape important decision agendas and cognitive frameworks, such as the IAIS Solvency framework. However, ultimately the outcome is that both public and private actors still benefit from this ‘supply and demand’ exchange because public actors can provide face-time opportunities for *potential* influence which is considered by private actors to outweigh the minimal cost involved, while private actors can provide their more abundant material resources which is considered by public actors to outweigh the structured ‘air’ time they need to give in return.

¹⁹⁷ Based on confidential interview with an IAIS Observer

6

The International Accounting Standards Board and the prudential application of fair value

This study has so far canvassed the issue of private influence in financial standard-setting forums that consist primarily of regulators. However, financial standard-setting is no longer exclusively undertaken by regulators but can also be exercised by entirely private bodies. Perhaps the most well known example of this in current academic literature is the high-profile role played by the International Accounting Standards Board (IASB) in the setting of international accounting and financial reporting standards. In the case of the IASB, these private actors are setting international standards and hence influencing outcomes for both their public and private constituents. Instead of looking at the role private actors play in using their power to influence public actors in the setting of standards, the IASB requires us to look at how as a private body, it has influence in a way in which fundamentally impacts the regulatory roles undertaken by governments and supervisory authorities.

This case in other words requires us to look at this study's theoretical framework in a slightly different way, by examining whether firstly, a supply and demand dynamic can be established between public agencies and private 'authorities'; and secondly, whether the same types of institutional practices are used by public agencies to enhance the authority of private bodies or, if they are perceived to threaten regulatory prerogatives, constrain their authority. This chapter argues that evidence can be found to support these

propositions, namely that there has been a high demand from public regulators and agencies for international harmonised accounting standards, which the IASB was pivotal in supplying. However, when private authority was deemed to undermine the prerogatives of public agencies, institutional practices were used to fundamentally constrain the IASB's standard-setting ability.

The empirical case used to support these propositions was the IASB's paradigmatic shift from historic cost to fair value accounting by way of its introduction of the fair value option in accounting standard IAS39 (Perry and Nolke 2005, 2006). Whilst initially the IASB was seen to provide public agencies with an important technical capability that these public agencies could otherwise not generate themselves, this chapter also finds that this paradigmatic shift has not necessarily occurred without significant constraints imposed by public agencies. Specifically, when the development of IAS39 began to encroach on the authority of prudential regulators, these public actors imposed their own institutional constraints that have curbed the full application of the accounting standard. These constraints have meant that the application of fair value has not been applied for prudential reporting purposes. Consequently, this chapter finds that the IASB can also be shown to be a case of high demand from public agencies which has corresponded with a perceived threat to regulatory authority, thereby leading to the imposition of institutional constraints. It then proceeds to explain why these agencies have been able to impose these constraints on the IASB in a 'macroprudential'¹⁹⁸ world of rule making.

¹⁹⁸ For a definition and overview of macroprudential regulation, see the BIS Working Paper

6.1 High demand, low threat: achieving international harmonisation and the ascendance of the IASB

The IASB and the demand for international harmonisation of accounting standards

The high profile nature of the IASB in recent years as an international accounting standard setting body is not so much the result of the work they have undertaken *per se* but rather the private nature of who they are and the significant impact their work ultimately has on global financial market governance. Indeed, in a relatively short span of time, the IASB (and its predecessor the International Accounting Standards Committee – the IASC) has been catapulted to the forefront of international financial governance due to the fact that its standards, unlike many other international financial standards, are now legally binding in many parts of the world¹⁹⁹. The mandatory nature of the IASB's international accounting standards therefore raises serious questions about the IASB's legitimacy as an agency of governance and its ability to ultimately produce 'public goods' for global markets²⁰⁰.

The IASB as a 'private authority' has attracted widespread scholarly attention for varying reasons²⁰¹, but perhaps the most common reason is because of its private nature in conjunction with the significant influence it has over determining the financial reports of public companies around the

No 128 'Towards a macroprudential framework for financial supervision and regulation?' by Claudio Borio, February 2003 found at <http://www.bis.org/publ/work128.pdf?noframes=1>

¹⁹⁹ For example, the EU (from 2005), Australia (from 2005), Canada (from 2011), NZ (from 2007), Russia (from 2011) Turkey from 2006

²⁰⁰ For example, see Mattli, W and Buthe, T (2005a) for discussions on issues concerning the accountability of the IASB.

²⁰¹ For more general discussions on private authority, refer to Cutler et al (1999)

world. The international accounting standards that the IASB produces (the International Financial Reporting Standards or 'IFRS') are now used in almost 100 countries and in some parts of the world, are also legally binding through their domestic laws²⁰². Whilst not entirely 'global' yet in scope, given that one of the most important jurisdictions – the United States (US) – still maintain their own Generally Accepted Accounting Principles (GAAP) developed by the Financial Accounting Standards Board (FASB), the 'global' structural reach of the IASB is not far off in light of the landmark Memorandum of Understanding (the 'Norwalk Agreement') reached between the FASB and the IASB in February 2006. This agreement is significant as it is the first time that the two 'rival' standard-setters agreed to "to co-ordinate their future work programmes to ensure that once achieved, compatibility is maintained."²⁰³ It is also significant because it is a very public recognition that the work undertaken by the IASB directly impacts the work undertaken by the FASB and vice versa. Also, according to the IASB, it also recognised the fact that "many national GAAPs are based on IFRSs."²⁰⁴

So how has the IASB been able to reach this position of authority? Although this question merits a much more detailed analysis of the various factors that have contributed to the rise of the IASB²⁰⁵, this chapter focuses on the argument that the rise of the IASB coincides with the inability of the

²⁰² Specifically, 75 countries now require all or some publicly traded companies to use IFRSs, 25 more countries permit public companies to use IFRSs and at least 50 countries require or permit IFRSs for non-public companies. IASB presentation: Progress on Adoption, Progress on Adoption, Convergence, and Convergence, and Implementation: Survey Results, found at <http://www.iasb.org/NR/rdonlyres/86EBDC8A-5BAE-46EB-8540-08F4B65E0146/0/0609WSSConverge.pdf>

²⁰³ Refer the IASB website, About Us found at <http://www.iasb.org/About+Us/International+Accounting+Standards+Board+-+About+Us.htm>

²⁰⁴ IASB presentation: Progress on Adoption, Progress on Adoption, Convergence, and Convergence, and Implementation: Survey Results, found at <http://www.iasb.org/NR/rdonlyres/86EBDC8A-5BAE-46EB-8540-08F4B65E0146/0/0609WSSConverge.pdf>

²⁰⁵ For historic overviews of the rise to the IASB, see for instance Katsikas (2006) and Dias (2005)

US and the European Union (EU) to reach agreement over accounting standards harmonisation and what this study argues to be the resultant demand for an alternative forum²⁰⁶. The argument put forward by Katsikas (2006) for instance centres on the idea that regulators will resort to non-state or private transnational governance when they are unable to satisfy domestic constituencies through inter-state agreements. By adopting Katsikas's argument, this study proposes that a demand for an alternative forum will give rise to a demand for private capabilities.

By way of brief historical background, it was largely the changes that resulted in the international financial system in the early 1990s, namely privatisation, which led to an increase in the desire for foreign companies to list in one of the largest capital markets in the world – the US. Foreign companies recognised the need to tap into this market in order to pursue global strategies of expansion and growth (Martinez-Dias 2005, Katsikas 2006). However, one of the biggest hurdles for foreign companies wishing to list in the US for instance was the stark differences in listing and disclosure requirements, imposed by the US Securities and Exchange Commission (SEC).

The US exchanges began to worry that the cost for foreign companies to maintain essentially two separate financial accounts – for its home jurisdiction and for the US requirements would eventually be too prohibitive and the benefits of listing on the US exchanges would soon be lower than the costs. As a result, regulators within the US and the EU began to face increasing pressure to harmonise their accounting requirements to facilitate

²⁰⁶ See for instance Katsikas 2006 who refers to the notion of 'forum shifting' derived from Braithwaite and Drahos (2000).

their cross-border activities (Martinez-Dias 2005, Katsikas 2006). In the US, pressure on the SEC came mainly from the American stock exchanges seeking to capitalise on the demand for foreign listings. The European Commission (EC) also felt pressure from primarily the major European firms, especially German and Swiss-based enterprises, who began to unilaterally adopt US GAAP and International Accounting Standard (IAS) standards in the mid-1990s (Martinez-Dias 2005). The EC adoption of US GAAP was considered politically unpalatable, where the “unilateral export of US GAAP would be labelled “accounting imperialism” and was unacceptable to the European Commission” (Martinez-Dias 2005: 15). The US was also opposed to harmonising their GAAP system based on the IAS, which they believed to be under-developed compared to their standards (Martinez-Dias 2005).

It was therefore essentially the relative ‘neutrality’ of the then obscure London-based standard-setter which appeared to offer the contending regulatory agencies a solution to their deadlock over harmonisation. There was, in the words of this study’s framework, a very high demand for an international accounting standard-setter that was based neither on the US nor EU system of accounting. The IASC therefore provided a politically palatable and alternative source of technical expertise which both sides of the Atlantic would be willing to comply with.

The IASC also capitalised on this demand from regulatory agencies by building better networks with domestic accounting agencies and eventually by transforming itself “from a collegial, private interest association...to a hierarchical centralised international organisation” (Donnelly 2007: 118). The IASC was initially set up in 1973 as an overarching private international

organisation representing professional accounting bodies from Australia, Canada, France, Germany, Japan, Mexico, the Netherlands, the United Kingdom and the United States. This organisational base however was eventually considered by the IASC itself as too limited and in 1999 it set out to restructure and reposition itself as a much more global standard-setter, with the specified aim to gain “support for IASC as the most appropriate organisation to play the pivotal role in the development of a single set of global standards.”²⁰⁷ As a result, in March 2001 the IASC Foundation (IASCF) was established as the parent entity of the “independent, privately-funded accounting standard-setter”, the IASB.

Political pressures and the need to satisfy domestic constituencies lead to the high demand from both US and EU regulators for what essentially the IASB could offer – a set of international standards that companies on both sides of the Atlantic could use as the basis for global reporting. This study also argues that regulators not only had a demand but utilised important institutional tools to secure the rise and prominence of the IASB and the ability of the IASB to develop internationally accepted standards.

Enhancing the IASB’s capture of international accounting standards: institutionalised endorsement of International Accounting Standards

One important factor which has led to the endorsement of IASB authority is the role public agencies and other international organisations have played in legitimising its governance role²⁰⁸. States and regulatory agencies for

²⁰⁷ Recommendations on Shaping IASC for the Future: A Report of the International Accounting Standards Committee’s Strategy Working Party Recommendations to the IASC Board, November 1999, found at http://archive.iasb.org.uk/uploaded_files/documents/8_210_swp_rep.pdf

²⁰⁸ For a more detailed discussion on why public actors may delegate authority to private authorities see Mattli and Buthe (2005a)

instance have played a crucial role in legitimising the authority of the IASB's technical supremacy by institutionalising the standards in to domestic law. The most significant endorsement given to the IASB (and its predecessor the IASC) has no doubt come from the EU when EU members were required to adopt its accounting standards though namely the Fourth and Seventh Directives²⁰⁹.

However, more significantly is the recent and more explicit recognition given to the IASB by the EU in the form of Regulation (EC) No 1606/2002 adopted in 2002 where from 2005, "all listed EU companies (including banks and insurance companies) must prepare their consolidated financial statements in strict accordance with IAS."²¹⁰ Many other states have also followed suit including Australia, Canada, New Zealand, Russia, and Turkey to name a few²¹¹. Furthermore, and according to the IASB, several more large jurisdictions are on their way towards making IFRS legally binding as well²¹². Most notably, India announced that IFRS will be mandatory in India for financial statements for the periods beginning on or after 1 April, 2011²¹³. As one IASB Board member acknowledged "one of the really interesting, unique features of this international organisation is it is a private organisation whose product is being embraced by governments all

²⁰⁹ Directives found at Europa portal <http://europa.eu/scadplus/leg/en/s70001.htm>

²¹⁰ Regulation found at Europa portal, <http://europa.eu/scadplus/leg/en/lvb/l26040.htm>

²¹¹ Australia (from 2005), Canada (from 2011), NZ (from 2007), Russia (from 2011) Turkey from 2006

²¹² Confidential interview with a IASB Board Member conducted in 2006

²¹³ Refer the Institute of Chartered Accountants of India (ICAI) announcement 'Convergence with IFRS From 1st April 2011, Where We Stand as on 02-02-09 - (05-02-2009)' at http://www.icaai.org/category.html?archive=&c_id=219&page=15

around the world...I mean, I think its amazing that so many governments are basically abdicating a sovereign responsibility to a private organisation...”²¹⁴

In addition to endorsement at the state level, the IASB has also been embraced by international organisations as a core part of the ‘global architecture’. For instance, the IASB standards are one of “the eleven key ‘issue’ areas for governance” from which the International Monetary Fund (IMF) and World Bank base their Financial Sector Assessment Program (FSAP) and Reports on the Observance of Standards and Codes (ROSCs) surveillance²¹⁵. Recognition that the IASB is not simply a private interest body but is in fact undertaking a more ‘public’ role has also been widely acknowledged by the wider regulatory community. The General Manager of the Bank for International Settlements (BIS) for instance has argued that the global policy orientation towards fostering financial system stability encompasses not only the roles played by macro prudential regulators such as central banks and prudential supervisors but is also a framework which “naturally goes hand in hand with global financial reporting practices” (Knight 2004). As he further explains, “sound and internationally harmonised accounting standards are important for a well functioning and stable financial system” and that “it is important for overall financial stability that accounting and prudential standards are mutually consistent to the extent feasible.” (Knight 2004)

²¹⁴ Confidential interview with one of the IASB Board Members, November 2006. References to the Board Member interviewed in this chapter refers to only one Member interviewed for this study.

²¹⁵ Refer the IMF website <http://www.imf.org/external/NP/fsap/fsap.asp>; These are namely data dissemination, fiscal transparency practices, monetary and financial policy transparency, banking supervision, insurance supervision, securities market regulation, payments systems, corporate governance, accounting, auditing and insolvency regimes and creditors' rights.

The “intense efforts” that are under way to establish a common set of internationally accepted financial reporting standards (IFRS) are also said to reflect “now a broad consensus over their importance for the proper functioning and stability of the financial system.”²¹⁶ Furthermore, like the IMF and World Bank, the influential Financial Stability Forum represented by the three major financial standard setters the Basel Committee on Banking Supervision (BCBS), International Organisation of Securities Commissions (IOSCO) and the International Association of Insurance Supervisors (IAIS) has also officially recognised that “alongside core principles for prudential frameworks in banking and insurance, accounting standards have been included among the 12 standards identified by the Financial Stability Forum as conducive to a robust financial infrastructure.”²¹⁷

This study proposed that the normative practices used by regulators when facilitating capture include instances when norms are not only sourced from private actors, but also shaped by private actors. These norms are then introduced and adopted by public agencies. Furthermore, it was also proposed that public agencies would grant private actors decision making authority in order to facilitate capture. As the legitimisation of the IASB through domestic legislation shows, public agencies and international organisations have indeed not only sourced accounting norms from the IASB but they have also allowed them the decision authority to shape these norms, which public agencies have then adopted through domestic institutional channels.

²¹⁶ Ibid

²¹⁷ Ibid

So what are these norms? The official view given by the Organisation for Economic Cooperation and Development (OECD) defines accounting standards as methodologies and disclosure requirements for the preparation and presentation of financial statements. They are usually developed within the institutional and professional framework of a country and promulgated by regulatory or professional accountancy bodies. Importantly accounting standards may also be developed in harmony with, or as an adaptation of, an internationally recognized set of benchmark standards such as the IASB or the US GAAP as promulgated by the FASB²¹⁸.

According to Perry and Nolke (2006) however, accounting impacts the lives of everyone in society because accounting is a system for measuring economic activity; however the accounting numbers themselves are not simply factually objective numbers and recorded after the event, but rather, form the basis for such activities in the first place. In their words, “the way in which assets are valued and defined is thus a central parameter in socio-economic relations” (Perry and Nolke 2006: 561). Therefore those in the position to shape and define this value and measurement system have significant impact over the actions and choices that the economic society can make. Mattli and Buthe also reiterate this view, arguing that what may seemingly appear “technical”, such standards to the contrary, act to create incentives and disincentives “through which they shape the behaviour of firms and consequently aspects of a country’s political economy” (2005a: 400).

²¹⁸ Refer to OECD site <http://stats.oecd.org/glossary/detail.asp?ID=4463>

A further indication proposed in this study that normative practices have been used to facilitate capture is when those norms adopted by public agencies allow private actors to self-regulate. This has also been seen in the IASB's somewhat controversial shift from its former historic cost accounting methodology to one that is based on 'fair value'. The IASB's ability to offer "a single set of high quality, understandable and enforceable global accounting standards that require transparent and comparable information in general purpose financial statements"²¹⁹ is a key point of contention for Perry and Nolke because of the underlying basis on which it has formed its new system of economic measurement and hence governance. They argue that the "newly instituted accounting techniques for defining and valuing business assets, chief among them fair value accounting, are integral to the ongoing reorientation of the international political economy...the new standards represent a shift in power from production to finance." (2006: 560)

Indeed, the IASB has increasingly based its new global system of accounting on the principle of 'fair value' – that is, "the amount for which an asset could be exchanged or a liability settled, between knowledgeable, willing parties in an arm's length transaction."²²⁰ What underlies this definition is the disputed methodological practice underpinning this 'fair' amount, which is either a market value of a transaction at today's prices (as opposed to what a buyer and a seller paid at the time of the transaction or 'historic cost' accounting) or, where an asset is not actively traded, a simulated model of a market and its value (Perry and Nolke 2006). By relying

²¹⁹ Refer IASB website

<http://www.iasb.org/About+Us/International+Accounting+Standards+Board+-+About+Us.htm>

²²⁰ IAS39 Technical summary found at <http://www.iasb.org/NR/rdonlyres/339C384D-045B-47D7-AA8E-8D26DFA726FB/0/IAS39.pdf>

on what the 'market' sees as the inherent value of an asset, "fair value accounting shifts power from managers to markets, which benefits shareholders...market-based asset prices do not represent some sort of abstract social equilibrium, but rather they represent the actions of marginal buyers and sellers, driven by the views of dominant market analysts and pundits who do not necessarily make the long-term calculations which reflect broader societal interests." (Perry and Nolke 2006: 566) It allows, in other words, those in the market to determine the value of their own assets and transactions.

Why has this 'shift' occurred? Mattli and Buthe argue that this has largely occurred because of the dominance and attraction of the American and British capital markets for global business and hence in their words, "it is not surprising that Anglo-Saxon experts are central in shaping international accounting rules" (2005b: 256). In their view, the Americans and the British have arguably had the most extensive experience writing rules for their respective national capital markets because these are the largest capital markets in the world. Furthermore, they also argue that because stock markets have historically been the main source of capital for firms, the needs of investors have been the main consideration in the development of accounting standards. This is in stark contrast they argue, with the most continental European countries where the main purpose of financial statements has been for tax assessment purposes and for the protection of creditors. Therefore unlike the continental European tradition which is "enshrined in tax laws that are the products of democratic political process",

the Anglo-Saxon model is one in which “accounting rules result from private-sector processes funded by industry” (Mattli and Buthe 2005b: 255-256).

The governance and funding structure of the IASB illustrates how the IASB has been able to shift to this paradigmatic shift towards ‘fair value’ accounting. The compositional make up of the IASB structure, as well as the revenue arrangements which have funded the IASB to date are pinpointed as key reasons for the IASB’s push towards the ‘financialisation’ of accounting standards (Perry and Nolke 2006). As discussed earlier, in March 2001 the IASC Foundation (IASCF) was established as the parent entity of the IASB. The IASC Foundation oversees two main bodies, the Trustees and the IASB²²¹. The IASB is ultimately overseen by the Trustees of the IASCF and it is the Trustees who are responsible for appointing the members of the IASB as well as determine its overall strategy and standards agenda. Even though the Trustees do not have a direct role in the setting of the accounting standards, they appoint those whom they consider the most appropriate candidates to undertake the standard-setting role and establish their work agenda.

So who are these Trustees? The majority of the IASCF Trustees come from the financial/accountancy sectors, which include investment banks (for example Morgan Stanley, Merrill Lynch, Capital International, Nomura), investment firms (for example Omega Capital, CA IB Corporate Finance, Uranus Investment Holdings) and accounting/consultancy firms (for

²²¹ The IASC Foundation also oversees the newly Standards Advisory Council (SAC), a forum providing the IASB with the opportunity to consult individuals and representatives of organisations affected by its work and the International Financial Reporting Interpretations Committee (IFRIC), a derivative of the former IASC’s Standing Interpretations Committee (SIC). Refer IASB website for more details <http://www.iasb.org/About+Us/About+the+Trustees/About+the+Trustees.htm>

example Ernst and Young and Pricewaterhouse Coopers (PWC))²²². The IASB in comparison is much more evenly distributed in terms of the technical background of the Members represented. Their backgrounds as long standing accounting standard setters, academics or accountants by trade²²³ fulfil the IASCF Constitutional requirement that “the main qualifications for membership of the IASB shall be professional competence and practical experience...[and] will comprise a group of people representing, within that group, the best available combination of technical expertise and diversity of international business and market experience in order to contribute to the development of high quality, global accounting standards.”²²⁴

However Mattli and Buthe argue that such ‘technical’ expertise also reflects again on the measure of Anglo-Saxon influence over accounting rules (2005b: 256). When the IASB was formed in 2001, the US, UK, Canada, South Africa and Australia together accounted for no fewer than 10 of the 14 Board Members and as currently stands, the Board is still heavily represented by the Anglo-Saxon world with only 5 of the 14 Members now from non-English speaking jurisdictions²²⁵.

Even though the IASB is recognised for its technical prowess, the IASB Board also establishes key working groups that give the IASB “access to additional practical experience and expertise”²²⁶. According to the IASB, the composition of the working group “reflects the diversity and breadth of

²²² As at 2007-2008.

²²³ For the IASB Board Member backgrounds, refer to IASB Members section at <http://www.iasb.org/About+Us/About+the+IASB/IASB+members.htm>

²²⁴ IASCF Constitution, paragraph 19, found at <http://www.iasb.org/NR/rdonlyres/A3010B6C-3F80-401F-BE81-359E1E015E22/0/Constitutionfinal.pdf>

²²⁵ As at January 2009 – the five Board Members from non-English speaking jurisdictions are from France (two Members), Sweden, Japan and China.

²²⁶ From the IASB Working Groups site at <http://www.iasb.org/About+Us/About+Working+Groups/Working+groups.htm>

interest involved in a particular area. The Trustees' Procedures Committee reviews the proposed composition of each group to ensure that there is a satisfactory balance of perspectives."²²⁷ Even though the IASB states clearly that it is solely responsible for setting the working group's mandate and objective, and that groups are not asked to develop formal recommendations, the IASB can rely significantly on the specific expertise provided by these groups. This is because despite their high level of proficiency in accounting expertise, they as a group may not be able to know the intricacies of the way certain products or transactions are conducted in 'real life'. For instance, one end-user group commented that because products and markets are changing dramatically from one year to the next, the IASB Board 'can not possibly know or keep up' with the technicalities of these products without the direct input from those market participants. This was because "there are 14 Board members that have been out of the markets for a very long time now – they don't know how to account for a credit derivative [for example] – they just don't know because they've never seen these products in real life..."²²⁸

As such, the Working groups may not make formal recommendations per se but the Board can rely extensively on the knowledge inputs that these groups provide. One key example of this is the Financial Instruments Working Group, which was established to "help the IASB take a fresh look at the accounting standard IAS 39 Financial Instruments: Recognition and Measurement by examining and questioning the fundamentals of the standard ...[and] will therefore focus on improving, simplifying and ultimately replacing IAS 39 and will examine broader questions of the

²²⁷ Ibid.

²²⁸ Confidential interview with international industry association that represents financial institutions

application and extent of fair value accounting...”²²⁹ It is no surprise that out of the 17 members of this Working group, 9 members are from the world’s largest investment banking conglomerates and banking associations including Credit Suisse First Boston, BNP (now Banque BNP Paribas), Commonwealth Bank of Australia (CBA), Morgan Stanley, UBS, Hong Kong Shanghai Banking Corporation (HSBC), ING, Goldman Sachs and the Japanese Banking Association. A further 3 are from the Corporate Treasury functions of large international companies²³⁰. In the words of one large financial association who regularly provide input into the Working group process, “we’re not going to talk about accounting standards...because the IASB Board, they know that stuff, backwards and better than anybody else; what we’ll go in and talk about is the derivatives business, how its run, how portfolios are managed, how risks are offset, how you trade derivatives, and that’s the stuff the IASB appreciate the most and it’s the stuff that works in terms of getting a decent standard...”²³¹

To the casual observer, this composition of members would be expected given the nature of the expertise required to look at the recognition and measurement of a financial instrument. In other words, one would expect practitioners to be able to provide information about what they practice. However, to others such as Perry and Nolke, this composition of ‘expertise’ only serves to reinforce the ‘selection bias’ of solutions that the IASB would ultimately take in to account; that is, the recognition and

²²⁹ From the IASB website

<http://www.iasb.org/About+Us/About+Working+Groups/Financial+Instruments+Working+Group.htm>

²³⁰

As at 2007-2008

²³¹ Confidential interview with international industry association that represents financial institutions

measurement of a financial instrument in accordance with what the large investment banks do. In their words,

“we view experts as political actors whose preferences set the ‘technical’ agenda and define the range of possible outcomes in a decision process. Expert knowledge is always political because it is always acquired in a particular social context, and reflects the political-economic structures and social relations which generated and which reproduce that context...Therefore, while the experts on the IASB committees may be independent in as much as they do not consciously make decisions to serve their material interests, the social context in which such expert knowledge has been acquired and practised is critical in determining which technical solution of the many possible ones is produced.” (2006: 578)

The sources of expertise and the IASB governance structure is also compounded by the IASB’s funding structure to date. Based on the statistics produced by the IASB in 2006, fewer than 200 companies and organisations worldwide provide the IASB with its funds, with approximately 72 per cent of the IASB’s funds sourced from corporations (including banks), accounting firms and business associations. In fact, corporations and banks currently account for 41.5 per cent of funding, compared to just 19.5 per cent provided by accounting firms. The IASB have recognised that their current funding structure “relying on a small number of voluntary contributions, would not be sustainable on a global basis”. In fact, as a consequence of this very narrow source of funding, the IASCF announced that it would establish plans for a sustainable, broad-based funding system when financing commitments for the IASC Foundation expired at the end of 2007. It has subsequently announced that it had secured funding from national sources and as at 25 February 2008, the IASC Foundation had secured £13 million in multi-year,

annual commitments from country-specific regimes towards a target of £16 million.

Thus, the fundamental change that has resulted from the IASB's governance over global accounting rules is the shift to fair value accounting. The legislative adoption and endorsement of these standards by public agencies lead some academics to ask "given the controversial character of fair value accounting, and its orientation towards a financial perspective, [...] Are the public institutions that are supposed to protect the broader social groups impacted, albeit indirectly, by accounting regulation represented anywhere in the standard setting process?" (Perry and Nolke 2005: 4)

The following section does indeed locate the role of public agencies in constraining the application of fair value when it was perceived to threaten their regulatory authority. This chapter finds that as a result of a high demand, but corresponding high threat from the IASB's shift to fair value, regulatory agencies (primarily those based in the EU) resorted to imposing institutional constraints in the form of norms and decision structures, which eventually forced the IASB to concede on aspects of the fair value methodology. These practices were used to reign in the IASB's standard-setting agenda, as well as impose new forms of decision authority over the IASB and its Trustees.

6.2 High demand, high threat: the politics of governing carve outs and prudential filters

Constraining Fair value: IAS 39, regulatory ‘carve-outs’ and prudential filters

The interests of the finance industry are closely tied to the fair value option in IAS 39 because it effectively promotes and compliments the transaction accounting undertaken by the large global banks. In its full application, the fair value option has the potential to increase the recognised profits of banks thereby boosting its shareholder value. However, the fair value option favoured by the finance industry has been significantly amended as a result of actions taken by public agencies, predominantly from the EU. This chapter has found that macro-prudential regulators - namely central banks and prudential regulators - have been pivotal in the IASB’s decision to substantially modify the fair value option so that it could fulfil prudential purposes – or, the purpose of protecting the principal beneficiaries such as deposit holders, investors, pensioners and the like – despite the fact that this modification was objected to by the vast majority of IAS 39 stakeholders (namely banks). They have been able to do this through what this chapter has argued to be the imposition of primarily normative practices, where regulators have imposed legislative ‘carve-outs’ and ‘prudential filters’ where IAS 39 accounting principles are not recognised for prudential measurement purposes. This means that regulated financial entities must report regulatory amounts that are potentially much higher than would be required under IAS 39.

The introduction of the fair value accounting framework began back in 1998 when the IASB's predecessor the IASC issued the draft IAS 39 titled 'Financial Instruments: Recognition and Measurement'. The draft IAS 39 included for the first time the proposal to require fair value accounting for *all* financial instruments. The revised IAS 39 released in 2003 formalised the 'Fair Value Option' for the first time, which permitted "entities to designate, at the time of acquisition or issuance, any financial asset or financial liability to be measured at fair value, with value changes recognised in profit and loss. This option is available even if the financial asset or financial liability would ordinarily, by its nature, be measured at amortised cost – but only if fair value can be reliably measured."²³² Furthermore, "once an instrument is put in the fair-value-through-profit-and-loss category, it can not be reclassified out"²³³.

This was indeed a significant move away from existing accounting practices, which applied a 'mixed model' approach of both historic (or amortised) cost and fair value measurement to financial instruments. Banking regulators in particular were from the outset fundamentally opposed to the standard and the fair value option because in their view "among the constituents of IASB, banking institutions can be regarded as the entities most affected by IAS 39" (Committee of European Banking Supervisors (CEBS) 2004a:1). This is because the sale of or trading in financial instruments were not only the core business of banks, but also because banks were applying both historic as well as fair value accounting to their financial

²³² Refer Deloitte IAS Plus, IAS Financial Instruments: Recognition and Measurement" found at www.iasplus.com/standard/ias39.htm

²³³ Ibid

assets and liabilities. Consequently, the most vocal opponents to the fair value option were the BCBS and the European Central Bank (ECB).

The BCBS for instance reported its assessment of IAS 39 to the former Group of Seven (G-7) Finance Ministers and Central Bank Governors in 2000²³⁴ and argued that “IAS 39...significantly increases the use of fair values in accounting for financial instruments, compared to both the existing international accounting standards and most countries’ national standards” and more importantly “the provisions of IAS 39 may have a major impact on how banks account for financial risks that are hedged” (BCBS 2000b: 2). The significant increase in the use of fair values and particularly its impact on how banks account for financial risks was considered a serious problem for banking regulators because it fundamentally differed in the way in which banks were accounting for financial instruments for regulatory purposes. As the BCBS set out in their report to the G-7 Ministers, “the approach to measuring risk positions in each main area of a bank’s activities – often described as the ‘trading’ and ‘banking’ books – is a matter of vital interest to supervisors” (BCBS 2000b: 7-8). This is because in most countries, banks were accounting for their ‘banking books’ and ‘trading books’ in two distinct ways – the banking book at amortised (historical) cost and the trading book at fair value. Thus, only items in the trading book were allowed to be fair valued through profit and loss (P&L) because as the BCBS categorically states “it is well established that for capital adequacy purposes fair value is the appropriate measurement basis for the *trading* book” (BCBS 2000b: 8).

²³⁴ The BCBS also made similar submissions to the IASB in 2000 and 2002. See BCBS comment letters at <http://www.bis.org/bcbs/commentletters/commentletters.htm>

However, the revised IAS 39 and the fair value option meant that in contrast to this treatment, items which were previously accounted for in the banking book at amortised cost could be fair valued through profit and loss²³⁵. This was considered fundamentally problematic for regulators because “under IAS 39, most financial liabilities will be reported at cost [and] reporting most liabilities at cost, while introducing more fair value accounting on the asset side of the balance sheet is likely to increase the risk of volatility in reported earnings and equity that may not reflect bank’s underlying risk management practices...” (BCBS 2000b: 4) Even more serious for regulators was the potential for IAS 39 to “lead some banks to make some changes in how they manage their risks” (BCBS 2000b: 15) or put simply, provide incentives for banks to use financial instruments for fair value gains reflected in earnings as opposed to managing and hedging their risks.

Similarly, the ECB stressed in its submission to the IASB that the application of a “full fair value accounting regime (applying to all assets and liabilities) to the banking sector gives rise to some serious problems and concerns” (ECB 2001: 2). Likewise, the ECB also reiterated that the application of fair value accounting “may be suitable for the *trading* book of banks, which refers to transactions (buying and selling) of marketable securities and related instruments with the objective of making profit from short term price variations. The use of fair value for these transactions is consistent with the availability of market prices and the short-term horizon” (ECB 2001: 2). However, the ECB also argued that the application of fair

²³⁵ Under the new classification of ‘available for sale’ – see IAS39 Technical summary found at <http://www.iasb.org/NR/rdonlyres/339C384D-045B-47D7-AA8E-8D26DFA726FB/0/IAS39.pdf>

value to the *banking book* of banks (to non-negotiable instruments such as loans) was “inappropriate” because the banking book was inherently concerned with longer-term decisions about credit quality and therefore less concerned about short-term market variations. Thus according to the ECB, “the introduction of fair value accounting for the banking book might in principle create incentives for banks to *alter their core business*” and above all “might induce banks to adopt an imprudent behaviour” (ECB 2001: 2). The ECB is categorical in its submission that “the ECB has a negative stance towards the possibility of applying a fair value accounting regime to the banking book of banks” (ECB 2001: 3).

These concerns conveyed to the IASB were reportedly raised by the IASB at their February and March 2004 Board Meetings where it had noted that it had received “comments from regulators about the permission of IAS 39 to designate any financial asset or financial liability as one to be measured at fair value with changes in fair value reported in profit and loss (the fair value option)”²³⁶. The fair value option had attracted so much negative attention from banking regulators from the outset that one IASB Board member confirmed in an interview that “issues” with banking regulators in relation to the fair value option made it very difficult for the IASB to proceed as intended with the full application of the new regime²³⁷. Another industry constituent also explained quite bluntly in an interview that it was fundamentally the BCBS’s (and ECB’s) threat that it would not recognise the option at all for regulatory purposes if the IASB did not amend certain things

²³⁶ Deloitte, IAS Plus, Discussion at the February 2004 IASB Meeting – Fair Value Option, notes found at <http://www.iasplus.com/standard/ias39.htm>

²³⁷ Confidential interview with international industry association

that halted the progress towards a final full fair value option in IAS 39²³⁸. For the IASB, the regulators threat would have created a very awkward outcome for a large section of the IASB's end-user constituency.

Consequently in April 2004, the IASB issued another revised Exposure Draft (ED) of IAS 39 which this time proposed to limit the application of the new fair value option to only specified circumstances and to require that the option only be applied to financial assets and liabilities whose fair value is verifiable²³⁹. The amendments, in the words of IASB Chair Sir David Tweedie, resulted from "a constructive dialogue with banking supervisory authorities...[with] the dual aim of meeting concerns that the fair value option might be used inappropriately while continuing to allow companies to use the option in appropriate cases to simplify the application of IAS 39" (IASB 2004). In the eyes of private industry however, the IASB had fundamentally capitulated in the hands of regulators. Given the fact that the amendments were made to primarily appease regulators, the ED caused widespread disagreement amongst private industry constituents that had already conveyed their full support for the *unrestricted* fair value option in the 2003 release of the draft IAS 39²⁴⁰. Of the 115 comment letters received, 76 per cent of respondents - all of whom were from the banking and preparer

²³⁸ Ibid

²³⁹ Specifically, the option could only be applied to a) Financial assets and financial liabilities that contained embedded derivatives; b) Financial liabilities whose cash flows were contractually linked to the performance of assets that are measured at fair value; c) Cases when the exposure to changes in the fair value of the financial asset or financial liability is substantially offset by the exposure to the changes in the fair value of another financial asset or financial liability, including a derivative; d) Financial assets other than loans and receivables; and e) Items that other Standards allow or require to be designated as at fair value through profit or loss; from Deloitte IAS Plus summary at <http://www.iasplus.com/standard/ias39.htm>

²⁴⁰ As outlined in the 2004 comment letters found at <http://www.iasb.org/Archive/Archive+IASB+Project+-+Comment+Letters.htm>. See also Deloitte IAS Plus Summary.

communities - rejected the proposals, disagreeing with the IASB's move to limit the fair value option because of regulatory concerns²⁴¹.

Excerpts from the major international banks illustrate this. For instance, the International Swaps and Derivatives Association (ISDA) argued that it “does not support the proposals in the ED to restrict the fair value option... [and] we do not believe the proposals to limit the use of the fair value option address adequately the concerns set out by regulators...”²⁴² Likewise JP Morgan argue that “In our comment letter dated 30 October 2003, on the proposed improvements to IAS 39, we agreed with the then proposal that an entity should be permitted to designate, irrevocably at initial recognition, any financial instrument at fair value through profit or loss (“the Fair Value Option” or “the Option”)...although we understand the issues raised by prudential supervisors, we believe that explicitly limiting the situations in which the Fair Value Option can be used is not the most effective means of addressing those issues and may result in restricting its legitimate use”²⁴³. Merrill Lynch also argued that it “believes that the restrictions... on the use of the Fair Value Option will not alleviate the regulator’s concerns over volatility in profit and loss. Therefore, Merrill Lynch does not support this ED as we believe the Fair Value Option should remain unrestricted”²⁴⁴.

Deutsche Bank also points out that “the requirement to disclose ... under the fair value option provides adequate information to address this concern of the regulators, who *under their own mandate* establish regulatory

²⁴¹ See Deloitte IAS Plus (statistics); also the authors own analysis of comment letters in the IASB archives found at <http://www.iasb.org/Archive/Archive+IASB+Project+-+Comment+Letters.htm>.

²⁴² Letter from ISDA, as outlined in the 2004 comment letters found at <http://www.iasb.org/Archive/Archive+IASB+Project+-+Comment+Letters.htm>

²⁴³ Letter from JP Morgan; *ibid*

²⁴⁴ Merrill Lynch Letter; *ibid*

reporting requirements.”²⁴⁵ [emphasis added] UBS also protested, arguing that “the initial proposal to include the fair value option (without restrictions) went through the IASB’s due process. The concerns that the exposure draft intends to address were debated in the original amendments to IAS 39, and the Board concluded not to restrict the use of the fair value option. We question, why the Board has decided to re-open this issue.”²⁴⁶

Even more controversial was the IASB’s inclusion of the *specific* reference to the oversight of regulators, where it was stated in the ED that “For entities subject to prudential supervision such as banks and insurance companies, the powers of the relevant prudential supervisor may include oversight of the application of these requirements and of relevant risk management systems and policies”²⁴⁷. Again, not surprisingly, respondents opposed such an inclusion in an accounting standard, with the London Investment Banking Association (LIBA) for instance arguing that, “references to the requirements of prudential supervisors have no place in an accounting standard...We would also be extremely concerned if any prudential supervisors believed this reference gave them the ability to overrule accounting requirements for the purposes of financial reporting; we believe the oversight of application of these requirements is a matter for entities and their auditors, rather than for their prudential supervisor.”²⁴⁸ ISDA too objected outright to this reference, arguing that “these concerns are outside the scope of standard setting and could potentially take the process of determining appropriate accounting policy away from accounting standards

²⁴⁵ Deutsche Bank Letter, *ibid.*

²⁴⁶ UBS Letter, *ibid.*

²⁴⁷ Deutsche Bank Letter, *ibid.*

²⁴⁸ LIBA comment letter, *ibid.*

setters and reporting entities.”²⁴⁹ Merrill Lynch also agreed, further reasoning that “as regulators have the power to request reports and submissions in their own specific format and in accordance with their rules, Merrill Lynch feels it is unnecessary for accounting standard setters to provide provisions for regulatory oversight within the standards themselves.”²⁵⁰

However, if that wasn’t enough, the BCBS – one of the key stakeholders taken in to account in the IASB’s decision to restrict the fair value option – argued in their submission that even though “the IASB has attempted to address some of the Committee’s concerns in its current proposal on the fair value option”, it did not, in the BCBS’s view go far enough. Instead, the BCBS argued that “the fair value option still raises a number of significant issues, particularly since the proposal does not appear to reduce the possible use of the fair value option” (BCBS 2004d: 4). For instance, the BCBS argued that the proposals did not “limit the problem associated with the ‘own credit risk issue’, or address ‘reliability’ concerns of whether fair values can be obtained directly from observable market prices and whether valuation models were robust enough (BCBS 2004d).

Furthermore, the BCBS argued that banks and other companies should be required to disclose their accounting and risk management policies that underpin the application of the fair value option because the proposal “does not require identification of the fair value option, nor the related gains or losses for each category reflected in the profit and loss account and in equity” (BCBS 2004d: 7). The BCBS did note however that one positive

²⁴⁹ ISDA comment letter, *ibid*.

²⁵⁰ Merrill Lynch comment letter, *ibid*.

aspect of the fair value proposal was for fair value to be applied to both asset and liability positions in financial instruments that were managed together which would reduce an accounting ‘mismatch’ (BCBS 2004d).

The IASB was, at the end of the 2004 consultation period, facing a serious dilemma. At the September 2004 Board meeting, the Board considered how it was going to proceed with the project, given that out of 116 comment letters received, most disagreed with the proposals contained in the April 2004 – including the regulators²⁵¹. Even though the overwhelming majority of respondents had expressed a preference for retaining the full fair value option, it was reported that the Board agreed that it could not revert back to the full fair value option because of regulatory resistance²⁵². Despite the IASB’s intention to be ‘independent’ and for all proposals to go through appropriate due process, “a general concern was raised regarding the reason why a particular constituency’s concerns, which appeared contrary to the majority’s view, were being considered so extensively by the Board. It was also pointed out that an overwhelming majority of respondents disagreed with the ‘possible new approach’ and fully supported IAS 39 with the unrestricted fair value option.”²⁵³ A large industry constituent also conveyed their frustrations in interviews, arguing that it was primarily power politics and “lobbying from the Basel Committee” that forced the IASB to act on their specific concerns. The problem with this was that “the Basel Committee...are users of accounts like anybody else...so the IASB [should] have treated them like users [but] they didn’t...”²⁵⁴

²⁵¹ Refer Deloitte IAS Plus Summaries

²⁵² Ibid.

²⁵³ Ibid.

²⁵⁴ Confidential interview with large international industry association

More significantly for the IASB however was the ramification of the BCBS's (and ECB's) concerns by way of the mounting political pressure that was yet to come. In November 2004, when the IASB was still 'undecided' on how it should proceed with the fair value option, the European Commission (EC) announced that it had adopted a Regulation endorsing International Accounting Standard (IAS) N° 39 *with the exception of certain provisions on the use of the full fair value option* (EU 2004). Specifically, "use of IAS 39, apart from the 'carved-out' sections, will be legally binding for all listed companies in the EU from 1st January 2005." (EU 2004) The EC's decision to apply the 'prudential carve-out' was explained as "based on observations from the European Central Bank and prudential supervisors represented in the Basel Committee of banking supervisors [which] the IASB took...into account when issuing an Exposure Draft in April 2004 limiting the scope of the full fair value option. However, the *IASB has not yet taken a final position* on this important issue." (EU 2004) [emphasis added]

Not only was the IASB therefore facing potential regulatory restrictions on the full use of IAS 39, but more significantly, its underlying authority to determine the content of their own accounting standards was also being undermined. The IAS 39 was the only standard that the EC had not fully endorsed, which was a serious enough precedent for the IASB to take notice. As the EC explain in their press release "as a general rule, the Commission will always prefer full endorsement of international accounting standards. However, IAS 39 currently represents an exceptional situation caused by particular prudential and technical complexities which have not been resolved." (EU 2004) The EC goes further, adopting a political

declaration stating “it expects the International Accounting Standards Board (IASB) to bring forward the necessary amendments to the current full fair value option by December 2004” (EU 2004).

As a result of the EC’s ‘carve-out’ based on the BCBS and ECB’s concerns, it did not take the IASB very long to agree to the amendments proposed by the BCBS. By February 2005, the revised new approach was presented to the Board for approval “in the light of constituents’ comments”²⁵⁵. The urgency to have the amendments go through the due process was evident in the IASB’s decision to hold a limited public roundtable on the new approach. It was reported that due to “time constraints, only certain constituents (approximately 30) would be invited to participate at those round-table discussions.” Furthermore, as Deloitte reported “it was indicated that some discussions had taken place with representatives of the Basel Committee and the ECB during which useful clarifications had been made of the concerns expressed previously with regards to the fair value option in IAS 39. Those clarifications had been incorporated into the redrafted document. The purpose of the round-table discussions was to solicit input from other constituents to ensure that the proposal was appropriate for all”.²⁵⁶ The IASB therefore was only simply going through the motions to get the amendment passed as quickly as possible. As a symbolic gesture, it was also reported that three of the IASB Board members had voted against the restricted fair value option in protest, but despite this, the new amended fair value option would proceed based on a 11-3 voting majority²⁵⁷.

²⁵⁵ Based on the Deloitte IAS Plus Summaries

²⁵⁶ Ibid.

²⁵⁷ Ibid.

In June 2005, the IASB issued its final IAS 39 Fair Value Option Amendment. Without exception, all the proposed amendments were based on the BCBS's 2004 recommendations²⁵⁸. In July 2005, the EC promptly "agreed unanimously to recommend endorsement of an amended version of IAS 39 relating to the Fair Value Option (FVO) previously carved out." (EU 2005) As further stated by the Commission, "after extensive consultation with third parties, the IASB published an amended version of IAS 39: Recognition and Measurement – the Fair Value Option (FVO) which improves the existing standard. The amended standard benefits from wide support, both from the financial services industry as well as from the European Central Bank and the Basle Committee of banking supervisors." (EU 2005) The fair value option therefore, did not seem very 'fair' at all to industry and to their astonishment, this 'very small constituency' had got not only some of their requested amendments, but almost all.

Regulators in the EU have been the major hurdle for the IASB's preference for the full application of the fair value option in IAS 39. The IASB has had to significantly scale back the fair value option in IAS 39 as "a direct response to concerns expressed by prudential supervisors of banks, securities companies and insurers that the fair value option might be used inappropriately" (IASB 2004). However, this was not the only normative constraint imposed. The final fair value option amendment attained by the BCBS should have appeased the concerns of the banking regulators, given

²⁵⁸ Specifically, the option had been further restricted to only allow fair value through profit and loss to a) those instruments classified as held for trading b) where designation eliminates or significantly reduces a measurement or recognition inconsistency ("accounting mismatch") c) those financial assets, financial liabilities or both that are managed on a fair value basis in accordance with a documented risk management or investment strategy; and d) those that contain one or more embedded derivatives. IASB, 'Amendments to IAS 39' 2005; IAS Plus Amendment to IAS 39 – The Fair Value Option July 2005 Special Edition; see also IASB IAS 39 Technical Summary

that the amended IAS 39 restricts the application of the fair value option to specified circumstances endorsed by the BCBS. However, for regulatory purposes this was not considered strict enough. The fair value option still contained outstanding issues that the banking supervisors wanted the IASB to include in IAS 39, which the IASB did not implement in its final amendment. As a result, regulators in response, led again by the BCBS, implemented their own 'prudential filters' where the application of certain aspects of the amended fair value option would still not be recognised for regulatory purposes. More specifically, regulated financial entities – that is, all banks - would not be allowed to recognise certain fair value gains and losses in the calculation of their regulatory capital.

One of these outstanding issues for example was in relation to the BCBS's concern that the fair value option, including the amended version of 2004, did not limit the problem associated with 'own credit risk' (BCBS 2004d). Specifically, the BCBS argued that the fair value option could result in gains and losses from changes in an entity's own credit risk (BCBS 2006) and hence strongly urged the IASB to "exclude the mark to market of own credit risk from the fair value option by limiting the mark to market of liabilities solely to valuation changes due to general market movements..." (BCBS 2006: 12) The IASB is reported to have discussed this issue at its December 2004 meeting, noting that "significant concerns had been expressed about 'own credit risk'". The Board also reportedly noted that although it "acknowledged that this is of concern...no recognition criteria will be introduced. The Board agreed a robust discussion of this issue and the

reasons recognition requirements in respect of this are not addresses would be needed in the basis for conclusions.”²⁵⁹

However, this decision by the IASB to go ahead and include changes in the credit risk of financial liabilities in the final fair value amendment did not mean that the BCBS would accept the status quo. In fact, before the IASB had even made their views on the issue public, the BCBS had already pre-empted the IASB’s decision when in June 2004 it went ahead and issued its own supervisory action. Titled ‘Regulatory capital *in light of forthcoming changes in accounting standards*’ [emphasis added], the BCBS argued that it had “examined the appropriate regulatory treatment of any gains and losses arising from changes in an institution’s own credit risk as a result of applying the fair value option to its liabilities...[and] believes that the potential inclusion of these gains and losses in Tier 1 or Tier 2 capital raises significant supervisory concerns and is of the view that they should be excluded. Accordingly, the *Committee believes it would be appropriate for national supervisors to not recognise these gains and losses in regulatory capital.*” (BCBS 2004c) [emphasis added]

Other regulators, particularly in the EU, followed. In October 2004, CEBS announced that it has proposed to the EU that it would use prudential filters in the context of the new IFRS and the proposed Capital Requirements Directive. It recommended member states “apply the guidelines applying IFRS for prudential purposes in order to avoid any unwanted change likely to be introduced by the new accounting rules” (CEBS 2004b). They further specify that “in accordance with the proposal of the Basel Committee...CEBS

²⁵⁹ Deloitte IAS Plus, op cit.

proposes exclusion from own funds of any cumulative unrealised gains and losses arising from changes in an institution's own credit standing as a result of the potential future application of liabilities of the fair value option" (CEBS 2004d: 4). Furthermore, CEBS stress that in line with the Basel Committee's work on the same subject "the objective of the guidelines [on prudential filters for regulatory capital] is to maintain the current definition – and quality – of regulatory capital" (CEBS 2004c: 1).

The prudential filters however did not stop there. A suite of others were to follow, including a further announcement by the BCBS in December 2004 that it had "considered additional issues related to the potential impact on regulatory capital of the implementation of certain International Financial Reporting Standards (IFRS)" including its recommendation for IAS 39's new recognition category of 'available for sale instruments', that "national supervisors to consider excluding unrealised gains and losses on loans designated as available-for-sale from the regulatory definition of Tier 1 and Tier 2 capital." (BCBS 2004e) Other filters also included the BCBS's recommendation for supervisors to exclude cumulative gains and losses on cash flow hedges that are recognised directly in equity from the definition of Tier 1 and Tier 2 capital (BCBS 2004c). Again, CEBS also followed the BCBS's direction and issued its own prudential filters for 'available for sale' financial instruments and cash flow hedges.

The BCBS's use of prudential 'filters' was unequivocally an attempt by the BCBS to pressure the IASB to succumb and amend IAS 39 to the full extent that the BCBS had requested. This is because so long as the prudential regulators maintained a separate interpretation of the fair value option and

IAS 39, the standard could not in the full sense of the word be 'harmonised' for all constituent entities – something that the IASB was determined to achieve²⁶⁰. In fact, not only would regulated institutions face the daunting administrative and compliance task of maintaining at least two separate definitions of equity – one measured for regulatory capital and the other for general purpose reporting - the IASB would also be constantly wary of how prudential regulators would be 'filtering' the use of their standard.

The shift towards fair-value accounting has therefore been highly influenced by regulators who have significantly restricted the fair value option for those constituents (that is, banks) who would stand to gain the most from a full and unrestricted application of the standard. They resorted to using their own institutional constraints in order to pressure the IASB to align with their regulations governing prudential capital. The framework proposed in this study predicted that regulators would, when faced with a perceived threat to their authority, resort to rejecting or removing existing private norms from regulatory standards. The EC 'carve-outs' were certainly exemplary of this form of institutional control, whilst the filters were aimed at ensuring that regulatory prerogatives would have to be taken into account by regulated end-users. This case therefore shows that institutional practises can be used to affect the choice sets of stakeholders and constituents, in this case the IASB and prudentially regulated entities, thereby constraining the IASB's ability to exercise its authority.

²⁶⁰ As stated in their website. Also confirmed in a confidential interview with an IASB Board Member.

Why the regulatory threat? The battle for methodological authority and the imposition of new governance structures for the IASB

In a crowded standards-setting world where private standard setters do have the authority and ability to determine outcomes independently and autonomously regardless of the various preferences of constituents, why did the IASB favour the ‘marginal’ interest group of regulators? Furthermore, why were regulators threatened by the application of the fair value option in IAS 39? The case of the fair value option in IAS 39 highlights that a key issue in the decision making capacity of private actors is not only the inter-linkage between ‘private’ and ‘public’ governance outcomes but more importantly their interests. The BCBS did not simply oppose the fair value option because it was a ‘public’ institution wanting to stand its ground against a private organisation and nor did it simply do this solely on the abstract grounds of protecting the wider ‘public interest’. Whilst the public interest and in particular the interests of beneficiaries such as deposit and policy holders are a key part of the regulatory mandate, it would be more accurate to argue that the fair value option impinged on the interests of *regulators* who have already established a preferred means of fulfilling and carrying out that public interest mandate. The fair value option was touching the core central nerve of the BCBS’s regulatory framework – the Basel II Capital Framework (Basel II).

In fact it was reported at the January 2005 IASB meeting that some Board members remarked “there was a possibility that there might in fact, be nothing wrong with the fair value option...” and “concerns raised by the bank regulators were in fact issues that they themselves could manage given their

mandate and that the debate around the fair value option was not really an accounting debate, but *possibly something else*.”²⁶¹ [emphasis added]

Indeed, it was in fact that ‘something else’ that was driving the main thrust of the BCBS’s stance on the issue, which they themselves outline in their submission to the G-7. For the BCBS, the fair value option had a direct impact on the reporting of *equity*, and equity in the language of regulators is *capital*. As far as the BCBS was concerned, banks and regulators around the world had already institutionalised a capital and regulatory framework which they had developed long before the IAS 39 fair value option. If the accounting standard setter wished to amend their methodology for valuing instruments that counted towards equity, their standard would have to work around the BCBS’s framework of banking and trading books. Above all, the BCBS is unequivocal when they declare that “accounting standards should *facilitate and not constrain* the effective supervision of banks.” (BCBS 2000b) [emphasis added]

In the case of the IASB, its decision to facilitate the supervision of banks in the case of the fair value option is the outcome of the IASB’s institutional enmeshment with the wider ‘macro-prudential’ governance world. The IASB is not an isolated private body with only formal contact with public actors; it is an institution that is now fundamentally embedded in the ‘new global architecture’ that governs for the global mandate of financial stability. The outcome of this enmeshment is that it has created mutually constitutive constraints on the decision capacities of *both* the private standard setter as well as the macro prudential regulators. Structural power

²⁶¹ Refer Deloitte IAS Plus Summaries.

therefore at the global standards level is more a case of structural constraint through enmeshment.

The IASB is ‘enmeshed’ with the macro-prudential world in two main ways. Firstly, as discussed earlier in the chapter, the IASB is regarded by states and international organisations as playing a fundamental governance role for the broader mandate of global financial stability. Secondly, public actors such as regulators are also ‘embedded’ within the governance structure of the IASB itself so that the IASB is reminded that its core constituents are not just private entities but also the broader economic society. This means that whilst the IASB’s technical capacity is essentially derived from the private sector, this technical capacity is regarded by the wider macro prudential standards world to be used first and foremost for the greater public interest mandate of ‘financial stability’.

This structural duality between the IASB as a private organisation with an embedded ‘public’ responsibility is also well recognised by the IASB itself. One Board Member explained “we take the view that whilst they [prudential supervisors] have different policy objectives than we have – it makes so much sense to try and work cooperatively so we don’t have duplication...so that if banking regulators think that a type of disclosure is really important for understanding the way in which the banks are operating and to impose some market discipline on banks, we would also think that is also pretty relevant for financial reporting purposes and so discuss how we can agree on what disclosures can meet both objectives”²⁶².

²⁶² Confidential interview with an IASB Board Member

This element of structural duality is most clearly shown in the IASB's final IAS 39 Basis for Conclusions. Even though the IASB could simply have made the fair value option amendments within IAS 39 without any further acknowledgment of the role played by regulators, it defied widespread private comments made by industry²⁶³ by taking one step further and including an *explicit* recognition of prudential regulatory governance in the application of the fair value option. Specifically, the IASB states that even though the objectives of prudential supervisors and the objectives of general purpose financial reporting fundamentally differed, the Board “acknowledged that for the purposes of determining what level of capital an institution should maintain, *prudential supervisors may wish to understand the circumstances in which a regulated financial institution has chosen to apply the fair value option and evaluate the rigour of the institution's fair value measurement practices* and the robustness of its underlying risk management strategies, policies and practices”²⁶⁴ [emphasis added]. By doing this, the IASB was not only defying its financial sector constituency's arguments that “references to the requirements of prudential supervisors have no place in an accounting standard” but it was also in effect, affirming the financial sector's “extreme” concern that “this reference gave [prudential supervisors] the ability to overrule accounting requirements for the purposes of financial reporting”²⁶⁵.

The question is, why would the IASB go to such lengths in recognising the governance role played by regulators and thereby potentially reducing its own authority? In other words, what ‘pay-off’ is the IASB getting by such

²⁶³ As exemplified by comments already cited in this chapter.

²⁶⁴ A copy of the Final Amendment Amendments to International Accounting Standard 39 Financial Instruments: Recognition and Measurement: The Fair Value Option, can be obtained from the IASB.

²⁶⁵ Comments made by LIBA, also outlined by others such as ISDA, Merrill Lynch and JP Morgan

enmeshment? As mentioned earlier, the IASB has enjoyed widespread recognition of its technical supremacy as global standard setter in accounting, not least because of the legitimacy that states and the wider ‘global architecture’ have given to the IASB in this role. Institutional enmeshment therefore has served the IASB well, by raising its profile and ensuring that its standards overcome the greatest hurdle of all – achieving ‘buy-in’ from states and public authorities. Without this legitimacy, arguably the IASB may have encountered many more public constraints like the ones constructed by the BCBS in the case of the fair value option.

However, a more practical implication of this ‘enmeshment’ is that by endorsing the authority of the IASB, public agencies have also pressured the IASB to structure its governance hierarchy to include regulators within its decision structure. For instance, the newly created Monitoring Board was established in 2009 (replacing the former Trustee Appointment Advisory Group) to “enhance the organisation’s public accountability by establishing a link to a Monitoring Board of public authorities”²⁶⁶. The Board is responsible under the IASC Constitution for the approval of all Trustee appointments and reappointments and importantly consists of two of the IASB’s vital stakeholders – the EC and the SEC²⁶⁷.

Furthermore, the newly instituted Standards Advisory Council (SAC) is also one of the four main IASB groups in which regulators occupy key positions, including the BCBS, the IAIS, IOSCO, and the European Central

²⁶⁶ The Monitoring Board consists of relevant leaders from the Emerging Markets and Technical Committees of the International Organization of Securities Commission (IOSCO), the European Commission, the Japan Financial Services Agency (FSA), and the US Securities and Exchange Commission (SEC). The Basel Committee on Banking Supervision will sit as a formal observer at Monitoring Board meetings.. Refer the IASB website

<http://www.iasb.org/About+Us/About+the+Trustees/Monitoring+Board.htm>

²⁶⁷ Ibid

Bank (ECB)²⁶⁸. The SAC also plays an important governance role in the IASB, as the forum where the IASB consults individuals, and representatives of organisations affected by its work. Crucially, the SAC gives advice to the IASB on a range of issues including input on the IASB's agenda, project timetables including project priorities, and consultation on any changes in agenda and priorities. According to the IASB, "in view of the importance of the IASB's agenda and priorities, once these have been determined by the IASB, changes thereto are expected to be the subject of consultation with the SAC."²⁶⁹ Furthermore, the SAC also "provides input to the Trustees on matters relating to the activities of the SAC or the IASB and any other relevant issues."²⁷⁰

It is proposed in this study's analytical framework that using the decision structure or specifically the governance hierarchy is a practice adopted by regulators to constrain the ability of private actors to capture outcomes. Consequently, regulators sitting in key governance positions within the IASB is not only indicative of the IASB's increasing institutional 'enmeshment' with regulatory authorities but it also crucially serves as a 'check and balance' to enable regulators to influence the decision outcomes of the IASB. The newly established Monitoring Board and SAC was a direct response to what one interviewee confirmed as significant "angst" among certain regulators, "particularly in Europe, concerned about the nature of [the IASB] and what they perceived to be a lack of accountability"²⁷¹. Furthermore, there was explicit recognition that public agencies and

²⁶⁸ Refer to the IASB website, About the SAC, <http://www.iasb.org/About+Us/About+the+SAC/About+the+SAC.htm>

²⁶⁹ Ibid

²⁷⁰ Ibid

²⁷¹ Confidential interview conducted with IASB in 2006.

governments would “never give [the IASB] power... what they’ve done is they’ve said ‘we’ll keep the power, but we’re going to use your product’ – that’s the way it is”²⁷².

6.3 Conclusion

The IASB has able to exert significant influence over the measurement of international economic activity through the formation of international accounting standards, but these standards have also been influenced by the interests of regulatory agencies. This chapter has found that the IASB’s paradigmatic shift to fair value accounting has been significantly constrained by regulators who have been able to impose their own institutional constraints on the application of the fair value option for prudential purposes. However, the IASB has not simply been forced to make the amendments to the fair value option due to regulatory pressure. The IASB has also made conscious decisions to incorporate and acknowledge the dual role played by regulators in the governance of the finance sector indicating elements of mutual cooperation due to macro-institutionalised enmeshment between global standard-setting institutions and their common mandate of financial stability. It has and is, in other words, also in the interests of the IASB to maintain their special supply and demand relationship with public regulatory agencies as it is this dynamic which contributes to the viability and legitimacy of their mandated governance role.

²⁷² Ibid

7

Conclusion

Private Influence in International Financial Standardisation: explanations and implications

It was the objective of this study to examine how private influence in international financial standard-setting forums operates in order to affect outcomes. The framework advanced in this study predicted that influence is based on the logic of supply and demand where regulators demand specific private power capabilities and private industry are able to provide these sources of power. Furthermore, capture is likely when demand from regulators is high, and regulators are unable to carry out their regulatory or policy making requirements without private power capabilities. The framework however also predicted that demand from regulators can also fall when the utility of the power capability wanes, or when they perceive their authority to be threatened as a result of utilising private power. When this occurs, captured outcomes would be limited.

The findings in this comparative study of international banking, insurance and accounting standardisation show that private actors play a pivotal role in the contribution of policy development and of financial governance more generally. The study reveals that whilst private influence can lead to outcomes that become captured by private interests, the findings also show that private actors are still fundamentally constrained and tempered by institutional mechanisms that determine the way in which they

can participate and exercise their power. One of the core propositions advanced by the study is that because regulators lack formal authority in transnational governance arenas, they adopt institutional practices as a substitute for legislative authority in order to either enhance or constrain private influence. The need for and the perceived lack of regulatory authority was crucial as to how regulators carried out the demand-side of their relationship with private actors and how they subsequently utilised institutional practices to enforce their authority.

This chapter focuses on the key comparative findings of the case studies and discusses how they support the propositions advanced in this study. The chapter then discusses the implication of these findings on the broader issue of private influence in global financial governance and highlights the problems associated with the dynamics inherent in the supply and demand relationship between regulators and private industry, particularly in financial governance. It also draws important lessons from these findings; in particular, the role that institutions can play in financial governance and how these relationships can be mitigated through institutional checks and balances.

7.1 Private Influence in International Financial Standardisation: comparative findings and explanations

High demand, low threat and evidence of capture: institutional practices used to facilitate private influence

In order to establish the empirical bases for capture, this study advanced the proposition that capture is based on a supply and demand relationship

between regulators and private industry, and when regulatory demand for a specific private capability is high; that is, when regulators are unable to fulfil their regulatory roles and policy requirements without the input of private power capabilities and these capabilities in turn enhance the authority of regulators.

Regulators and policymakers can actively seek the input of private industry to show at the very simplest level that they are performing their deliberative responsibility towards the constituency most affected by the proposed regulation. However as the findings in this study show, regulators capitalise on private capabilities because they may fundamentally depend on these sources of power in order for them to carry out their specialised roles and policy objectives. The case studies revealed that regulators did not simply deliberate with private actors on policy proposals but instead derived their capabilities from private industry sources at times when they could not generate policy outputs on their own accord because they lacked the resources, technical knowledge or expertise.

The Basel Committee on Banking Supervision (BCBS) was the most explicit case of this, where regulators explicitly acknowledged that they would be guided by industry about how best to revise the Basel II Framework (Basel II). Even though the BCBS is comprised of the world's most powerful economies and as a result would not appear to be lacking in any power capability, the BCBS was nonetheless restricted in its ability to undertake its role without information from its member jurisdictions as well as other non BCBS member countries. Moreover, it was also difficult to develop standards without an intimate knowledge of the way in which various financial

transactions worked and how financial institutions around the world operated, both of which needed to be provided by the banks themselves. Furthermore, relying on the banks to not only generate that information but to also package it in a way which would make the task of the BCBS easier was also the important pre-condition for promoting a 'win-win' outcome for both parties.

Due to the empirical circumstances surrounding the original inception of the International Association of Insurance Supervisors (IAIS), regulators had a more rudimentary demand for material resources in order to establish the organisation's ongoing viability as an international standard-setter. Public resources for various reasons were not only limited but also heavily dependent on one main 'jurisdiction', the United States (US). Private industry was not only capable of providing these resources but were also more than willing to supply this resource for the much more valuable benefit of gaining access to decision makers. In this case there was a mutual pay-off and reward. Regulators were happy to provide access to the forums in return for the resources because this was seen as less costly than having to ask for additional resources from their domestic constituencies.

At the global level of standard-setting, private authority in numerous industry issue areas abound. In the case of accounting, the International Accounting Standards Board (IASB) is arguably the only international authority in accounting standards, even though the Financial Accounting Standards Board (FASB) is to a large extent its most evident 'rival'. Public agencies have strategically selected the IASB to undertake a function that rival states, namely the US and from the EU, would not be able to conduct on

a domestic basis and the IASB has also been more than willing to provide this capability, particularly as it would serve to bolster their technical superiority in the face of a competitor, the FASB. The political sponsorship provided to the IASB and likewise, the resources the IASB was willing to expend providing this function, was also therefore an important relationship in which both parties would benefit from such an exchange. As a result, the IASB not only produces accounting standards for over 100 countries around the world, they are also now enforceable through domestic legislation in a number of countries, led most notably by the European Union (EU).

Importantly, in all three cases, this study found that regulators adopted institutional practices to facilitate and support this demand for private capabilities. A table of empirical examples exemplifying these various practices are outlined in Table 7.1 below, showing that regulators will attempt to use the institutional infrastructure to enhance the influence of private industry, predominantly through normative means.

Table 7.1 Institutional practices used to facilitate capture in the cases of the BCBS, IAIS and IASB

	BCBS	IAIS	IASB
Norms	Data collection on internal ratings systems from top 30 banks	Information sourced from IAA, drafted by IAA for solvency standard	Information sourced and private standards adopted through domestic legislation
	QIS data collection exercises	Internal models incorporated into Solvency standard	IAS used as part of the IMF and World Bank's FSAP and ROSCs surveillance
	Recalibration to produce capital incentives based on QIS data		Fair value paradigm a form of self or market-based regulation
	Basel II amended to incorporate revised incentives		
	Internal models approach a form of 'self-regulation'		
Process	QIS, QIS 2, QIS 2.5, QIS 3, QIS 4 undertaken with private industry input	Observers given access to meetings, documents from meetings and other opportunities to comment	
	Continual dialogue with industry for feedback on revisions	Observers able to give presentations directly to regulators	
	Presentations from banks provided to BCBS		
Decision Structure		Introduction of private Observer participation	Delegating decision authority to IASB through domestic legislative implementation

The finding that normative practices are used to facilitate capture in the development of international standards is not surprising, given that international financial standardisation is an exercise in norm creation based on what regulation should constitute based on what actors consider 'best' practice. These, as well as the complementary procedural and decision based mechanisms are argued to be the 'means' through which the supply and

demand of capabilities is transposed into outcomes, which in these cases are international financial standards.

However, what was accentuated in all three case studies was not only a high demand for private power when regulatory capacity was lacking, but also the facilitation of a demand from a *limited* supply of capabilities. An interesting finding that emerged from the case studies was that even though private actors were in the position of providing the sought after power capability, many found their capability rejected in favour of others that came across as being a more 'legitimate' source of that power. An economic approach to capture and interest group politics would reason that the size of the private coalition or homogeneity of interests would matter when it came to successfully providing a power capability. Though in the cases of the BCBS and IAIS, these factors had little to do with such 'selective capture'; instead, two observations made were the distinctions made between those who had 'technical expertise' and those who were labelled as 'lobbyists'.

For example, in the case of the BCBS, even though the large international banks most active in global financial markets would provide regulators with the required information, this information was categorised by the BCBS as being from either of these two 'technical' or 'lobbyist' sources. 'Technicians' were thought to be more legitimate than lobbyists as they were seen to be more 'objectively' proficient in the issue areas being debated²⁷³. By way of example, despite similar membership profiles and membership size, distinctions were made between information provided by the International Institute of Finance (IIF) and information provided by the International

²⁷³ Confidential interview with source from the BCBS

Swaps and Derivatives Association (ISDA). On the one hand, the IIF was regarded to be more useful as a ‘one-stop-shop’ for gauging the type of reaction the BCBS was likely to get from the big banks on new proposals or amendments²⁷⁴. Information from ISDA on the other hand was noticeably taken more seriously due largely to the explanation that they were technical specialists and therefore ‘objectively’ proficient in the issue areas being debated. Their information was therefore taken on board and their feedback on issues sought, evident in the contribution made to the definition of operational risk²⁷⁵.

Interviews with ISDA also confirmed this view of their organisation, explaining that it was “less political maybe than some other associations” and “that is how we have made our mark in that particular field”²⁷⁶. Moreover, ISDA also explained that it is not organised in the same way as those ‘other associations’ such that the Board was represented by the Chief Executive Officers (CEOs) of the major banking organisations (read like that of the IIF). Instead, the ISDA Board consisted of the Heads of the various technical areas of its member banking institutions such as those heading up the Derivatives, Legal, Trading desks and Risk Management areas that were “relatively senior within their areas but not as senior as the Chairman or CEO...”²⁷⁷ Thus, even though there is already a selection ‘bias’ that creates the conditions for capture, this capture is based upon a limited source of information, which is considered more technically ‘objective’ in the eyes of regulators.

²⁷⁴ Confidential interview with a source from the BCBS

²⁷⁵ Confirmed by sources from both the BCBS and ISDA

²⁷⁶ Based on confidential interviews with ISDA

²⁷⁷ Ibid

This was also found to be the case with the IAIS. Even though the IAIS has over 180 Observers officially included in the deliberation and development of standards, instrumental power capabilities provided by all Observer parties were not all treated equally. Special invitations extended to specific private industry representatives who were seen to be able to provide a specific technical capability on a particular topic or issue area, most notably the International Actuarial Association (IAA) was the starkest example of the differentiation between technicians and lobbyists. This was a source of great frustration for one Observer interviewed, claiming this to be highly biased and ‘unfair’²⁷⁸. Nevertheless, regulators of the IAIS selected notably the IAA for its expertise, allowing it opportunities to influence the underlying norms of standards. The IAA as a result had significant input into the finalised Insurer solvency framework issued in 2007, their contribution explicitly acknowledged in the standard.

What is observed in these case studies is that more often than not, regulators wanted to be affiliated and associated with ‘technical specialists’ who were in the game of providing objective and rational analysis of the subject matter at hand. This did not mean that the information was in fact objective or rational, but it was above all the *perception* of objectivity that mattered most. Obtaining their capability from what was considered by regulators as more legitimate or ‘objective’ sources enhanced their own credibility, as opposed to risking their professional reputation by being associated with vested domestic interests.

²⁷⁸ Confidential interview with large industry association

In the cases of ISDA and the IAA we can see that these organisations are in fact private standard-setters within their own industries, perhaps contributing further to their perceived legitimacy. Obtaining what was perceived to be technically objective financial norms was far more advantageous for regulators in consensus decision environments because these norms were much easier to adopt through the policy process. This is because these organisations had already undertaken the difficult task of harmonising domestically based interests, thereby producing private norms that had already been agreed to by a number of global financial firms²⁷⁹.

It also appeared more efficient and easier to manage fewer suppliers than it was to utilise a number of suppliers with potentially competing interests. In all three case studies, when demand for these capabilities was high, managing fewer suppliers allowed the regulators to utilise institutional mechanisms that would enhance their ability to produce the required standards. What we find in the standard-setting cases examined therefore is that demand from regulators from a select few private actors is the primary reason why a limited group of private actors had such a pervasive presence and role in each of the banking, insurance and accounting standards regimes. Strategically selected private actors formed part of the policy machinery because in all three case studies, they were specifically called upon to do so. These sources of power were called on primarily to help regulators (or the standard-setter in the case of the IASB) to fulfil their roles and mandates to establish global standards.

²⁷⁹ The ISDA Master Agreement is a standardised contractual arrangement that governs the terms and conditions of over-the-counter (OTC) derivative transactions and is used by banks and corporations globally. Refer ISDA website <http://www.isda.org/>

These findings therefore support the link between private influence and regulatory demand, but also importantly highlight a high demand for private capabilities from a select and limited group of actors. These actors were predominantly chosen because of their perceived technical expertise, as opposed to domestically vested interests, which in turn enhanced the credibility of regulators. At the global level of policy making and deliberation, it can be argued that this selectivity is the cornerstone of the supply and demand relationship that is generated to produce outcomes which benefit both regulators and a limited number of private actors.

However, an important consequence of this strategic selectivity was that regulators were not only able to choose their suppliers but it also then allowed them to control what they did with the supply. Controlling fewer suppliers can be potentially more efficient than exerting control over many diffuse and potentially competing interests. By using institutional practices to control supply, regulators in the case studies were able to obtain their power capability, use it to fulfil their policy requirements and facilitate predominantly the prerogatives of regulators, which were to either incorporate domestic regulatory considerations or to maintain or enhance their positions of authority over private actors. The findings in this study therefore also support the proposition that regulators use institutional practices to enforce their interests, exert their authority and as a result curb the extent to which private power capabilities determine standards outcomes.

*High demand, high threat and the imposition of institutional constraints:
US fragmentation and the EU's power over the 'policy machine'*

Capture in this study is certainly evident in all three case studies, where reliance on a select few private 'technicians' formed the basis of the supply and demand relationship with regulatory policymakers. Capture was argued in this study to be likely when demand for these capabilities were high, and regulators facilitated the adoption of private norms using institutional mechanisms. However, this study further proposed that capture would be limited (if not completely obstructed) if demand for private capabilities dropped and regulators have resorted to using institutional mechanisms to curb the extent of private influence over outcomes. The reasons proposed were that the utility of the power source has waned, or that regulators perceive their authority to be threatened by the use of private power.

For instance, when private capabilities were seen to be detrimental, regulators in all three cases have resorted to using the 'policy machine' to limit the adoption of private norms. Again, empirical examples of these institutional practices can be illustrated in Table 7.2, showing that the same practices used to facilitate capture can also be used to constrain private influence.

Table 7.2 Institutional practices used to constrain capture in the cases of the BCBS, IAIS and IASB

	BCBS	IAIS	IASB
Norms	Operational risk information sourced from industry, re-drafted by regulators to impose capital charge	EU Solvency II prerogatives included in standard	EC carve outs imposed on fair value option
	Capital Floors and calibration factors imposed to maintain aggregate levels of capital	Institutionalised distinctions between 'Regulators' and 'Observers'	IASB incorporation of prudential regulatory prerogatives in IAS 39
	Pillar 2 supervisory powers and discretion added		Prudential filters applied for prudentially regulated entities
Process	Consultation with industry stopped after CP3 in 2003 – final version released in mid 2004	Observers invited to participate in allocated time slots during meetings	
		Observers not permitted to engage in discussion unless called upon for views	
		Deliberation undertaken in last stages of standards development and limited time frame within which to provide comments	
Decision Structure	EU members represented on all three 'levels' of the committee structure	EU members forming the majority of the solvency sub-committee	New governance Monitoring Board imposed over Trustees and IASB, consisting of EU regulatory agencies
		Observers given structured access to meetings (partial opening, structured seating)	
		No decision making authority	SAC also established to ensure regulatory prerogatives included in agenda and standards
		Meetings closed when deemed for regulators only	

But which regulators? What was evident in all three cases was the domination of EU regulators over the standard-setting structures and policy processes. Simultaneously, US fragmentation also to some extent enabled the European regulators to take a lead on policy issues, made possible by the fact that the EU regulators had already undertaken EU-level deliberation on many of the issues, thereby producing common or united policy proposals based on EU legislative considerations.

We find for instance that private capture has been limited in the cases of Basel II, the Insurer Solvency Framework and IAS 39. Capture has been limited through the introduction of norms that ran counter to privately vested interests, through incremental policy changes to private norms that altered the incentive or benefits that accrued to private interests and also through limiting participation, excluding private actors at crucial stages of drafting and utilising only parts of information that private actors have provided. All of these institutional mechanisms fundamentally altered the way in which these standards benefit those actors who had the most to gain from the initial supply and demand relationship.

In the case of the BCBS, we see the introduction of new norms to counter the incentives provided by the Internal Ratings-Based (IRB) approaches, by way of the operational risk charge and other areas for capital increases included in Pillar 2 supervisory discretion. Despite the BCBS's intention to be guided by private industry in the design of Basel II, which in the words of one banking association representative "was supposed to be a bank-centred" initiative, we find after both the Second and Third Consultative Papers (CP2 and CP3) stages the BCBS introducing elements to

Basel II that ran counter to the interests conveyed by private industry during deliberations. The Quantitative Impact Studies (QIS) exercises for instance would confirm that amendments to Basel II would actually increase capital, as opposed to providing net incentives for the large IRB banks. Whilst the BCBS did amend the Framework to provide these incentives, overall they were considered to be very small, especially in light of the concern expressed by largely the IRB banks that the compliance costs associated with implementing the IRB approaches would offset any tangible benefits provided by the Framework.

There is therefore a parallel dynamic running through Basel II that is evident throughout the process. This is summed up by the BCBS and that is to provide incentives for the IRB banks as well as maintain aggregate levels of capital to Basel I levels (i.e. eight per cent minimum capital). As the case of Basel II shows however, these changes and ‘offsets’ were not necessarily the result of a strategic decision exercised by its members but rather the use of policy processes where changes were made ad hoc during the stages of sub-committee deliberations. These incremental changes made are evident in the form of these competing norms, where Basel II contains elements which both enhance and penalise large banks.

This supports the proposition that if demand for private capabilities was high, but correspondingly the threat to regulatory policy authority was also high as a result of using private capabilities, regulators would resort to using institutional ‘checks and balances’. This means that regulators would still consider the use of private capabilities as beneficial, if additional constraints were also put in place ensuring the policy authority of regulators.

This was seen in the case of the BCBS. Whilst US regulators championed the adoption of the IRB methodologies, which would provide tangible capital reductions to the more advanced banks, this private autonomy was in large part offset by other requirements introduced through the Basel II process that provided largely European regulators (and auditors) with the means to determine whether these IRB models were deemed appropriate or not through Pillar 2 supervisory discretion.

On the other hand, the study also proposed that when regulatory demand was low and correspondingly private capabilities were a threat to regulatory authority, regulators would put in place explicit constraints to control the ability of private actors to influence policy. This was certainly evident in the case of the IAIS. When the resources of private Observers had enabled the organisation to boost its funding, some regulators (again largely from the EU) began to feel uneasy about having private Observers involved in their activities. Unlike the BCBS deliberation process, which is largely undertaken 'behind closed doors' and undertaken as ad hoc amendments, what is interesting in the case of the IAIS is the use of transparent participation rules and protocols that are applied across the organisation. The IAIS was unique in the sense that it was both open and closed to having private industry Observers participate directly in their standard-setting activities. The IAIS also established very explicit rules about what Observers could and could not do. This was not only applied to the process of deliberation but even to small details such as seating rules and protocols concerning when Observers were permitted to participate and take part in discussions.

The effect of this institutionalised constraint is seen in the case of the Insurer Solvency Framework. The use of closed and ‘partially open’ meetings, which included the IAA only at specific points in the Insurer Solvency drafting process, meant that sections of the IAIS Solvency framework were derived both from the IAA’s contribution and the EU Solvency II directive. The IAA’s expertise was included only for sections of the sub-committee meetings, allowing the regulators to conduct their meetings at their own discretion, and inviting the IAA when they were most required. The fact that the regulators decided to open the insurer solvency meetings in 2005 to all Observers, when the framework was nearly finalised was no coincidence. Opening the meetings to all Observers was, it appeared, simply a formality but as the final phase of the project showed, Members had already ‘bought-in’ to the largely European dominated standard that was made to largely parallel developments that were occurring with the Solvency II project.

The effect of carve outs and prudential filters from European states and other regulatory agencies was also a more explicit use of institutional practices to constrain the IASB from implementing the full application of the fair value option in IAS39. These were direct actions designed to strong-arm the IASB into amending the standard to take into account the preferences of what many considered a small minority of ‘end-users’. The result of the carve-outs and prudential filters was that IAS39 was explicitly amended to recognise the prerogatives of prudential regulators, despite the fact that the accounting standards were for broader constituencies. For prudentially regulated financial institutions, the result is that they must still report

amounts much higher for capital purposes, than would be required for simply financial reporting purposes under IAS 39.

These practices were used because in all three cases, regulators from predominantly the European jurisdictions had their own domestic considerations to take into account, which were the Capital Adequacy (CAD) and the Solvency II Directives. Private norms and capabilities were undermining the prerogatives of the European regulators, which in the cases of the CAD and Solvency II, were to incorporate the necessary details needed to align with their domestic supervisory approaches. As a result, European regulators utilised the institutional infrastructure at the global standard-setting level to amend, constrain and even block initiatives that ran counter to their interests. This is not to say that the US regulators had no domestic interests that were at stake. On the contrary, as was explicitly seen in the case of Basel II, unable to exert common preferences through institutional mechanisms to enforce their interests, the US chose to opt out of the agreement altogether by developing their own domestic version of Basel II (or 'Basel IA') to suit its own political and regulatory prerogatives.

This ability by the Europeans to adopt institutional practices to control private participation was also evident in the IAIS. The US regulators were very critical of the fact that all meetings were not open and 'transparent' to all. The US Commissioners championed the need to have Observers involved in the standards-setting process and also be present at deliberations, which is similar to the arrangements in place in the US states. However it was again ultimately US fragmentation that allowed the European regulators to pressure Members to adopt explicit rules governing private participation and

deliberation. The ultimate reasons given as to why the US in essence acquiesced to the arrangements was because the US Commissioners did not take serious interest in the work of the IAIS and coordinating the views of the fifty different jurisdictions was logistically difficult to do²⁸⁰.

Why then, were the Europeans able to utilise the institutional infrastructure and the Americans resigned to exerting preferences through domestic channels? As Posner asks, “why did US officials become more accommodating and European officials, more influential; and why did the shift occur in 2002 and 2003?” (2006: 4) Mattli and Buthe (2003) provide insights into why the Europeans were better able to utilise institutional mechanisms at the global standards level than for instance, the US. Their ‘institutional complementarities’ approach posits that domestic standardisation systems involving high levels of hierarchy and consultation/coordination facilitate the accommodation of new layers of standardisation activity above the national level.

These features according to Mattli and Buthe (2003) are argued to offer greater complementarities with international standards institutions because of their ability to represent a broad-based domestic consensus with a single voice at the regional and international level. This is opposed to systems based on decentralization or institutional “anarchy” and market competition, where interests are fragmented, market driven and characterized by a high degree of internal competition. The European institutions based around the centralised EU regime is therefore far more advantageous in negotiations at the international level, than the US, which is characterised as institutionally

²⁸⁰ Based on confidential interviews conducted in March 2006.

more fragmented and hence more difficult to aggregate interests above the national level of deliberations.

The construction above all of a European-level regulatory regime enabled EU policymakers to not only consolidate their efforts to develop, implement and enforce financial services legislation but as Posner (2006) argues, these efforts have had a largely accidental consequence on transatlantic financial relations. One particularly important development in the EU what is important for this study was the introduction of the Lamfulussy process²⁸¹, which in essence formalised the rule-making procedures for insurance, banking and investment services legislation and above all establishes important mechanisms for coordination between European regulators to implement and enforce legislation (Posner 2006). In many ways, the influence of the Lamfulussy process, based around committees and formal processes for establishing both broad framework legislation and more detailed rules, can be seen in the international standard-setting regimes, due largely to the way in which European regulators have transferred their domestic institutional arrangements with their international deliberation.

Thus, the European prerogatives based around the centralised EU CAD and Solvency II, in conjunction with the hierarchical policy process characterised by the Lafulussy process and more formalised interaction with private industry suggest that the Europeans were more familiar with the ways in which institutional mechanisms can be used to enhance regulatory

²⁸¹ The Lamfulussy process is an institutionalised approach to the development of financial services regulations in the EU. Refer to: <http://europa.eu/rapid/pressReleasesAction.do?reference=IP/02/195&format=HTML&aged=1&language=EN&guiLanguage=en>

prerogatives for constraining private power. These domestic institutional characteristics in other words were highly complementary with the international standard-setting arrangements, and where they were not – in the case of the IAIS – were deliberately constructed to exhibit similar constraints. The US on the other hand, with its fragmented regulatory systems, was much less able to exert unified preferences, let alone enforce these through institutional mechanisms such as norm creation, policy deliberation and consensus decisions. This was not only evident in the lack of unity between US Insurance Commissioners in the case of the IAIS but also between the various US banking regulators that are part of the BCBS.

These findings highlight the important linkages between domestic institutional arrangements and those which are then transferred into the international arena. However, at the same time, these findings also raise important questions about how international financial standards regimes have come to be structured in the ways they have and whether domestic institutional complementarities are simply a coincidence or part of more intentional institutional designs, aimed to further the interests of certain jurisdictions. It also brings us to the wider question addressed at the beginning of this study and that is why these international standards regimes are structured to be exclusive, narrow and closed off to broader public constituencies. The following section argues that whilst European domestic institutional arrangements have influenced the structure in which the standards regimes have evolved, regulatory actors have also constructed new roles for themselves, as a result of their increasing engagement in cross-border financial ‘diplomacy’ (Slaughter 2004).

*International financial standardisation and the question of influence:
embedded outcomes and institutional enmeshment*

This study has found that capture and captured outcomes are a much more complex phenomenon than simply 'private actors getting their way'. As the case studies showed, there are instances of both capture and constraint, where aspects of international financial standards reflect private normative preferences as well as the vested interests of regulators seeking to enhance their authority. This is interesting considering that from the outset of the study, we wanted to examine how closeness and private participation led to capture at this transnational level of governance. It is therefore evident that 'participation' is a function of the institutionalised practices that were evident in all three case studies.

One of the comparative methods used in this study was to apply the Most Different Systems Approach to the three cases examined. Namely, despite the variations in the membership composition of each case study and differences in issue area, this study wanted to ascertain whether in fact they maintained similar supply and demand relationships and whether similar institutional practices were utilised to support the supply and demand dynamics. What this study found was that despite these initial institutional variations being treated as a constant, there were in fact markedly similar institutional characteristics across the three standard-setting organisations. Not only were their decision structures the same, revolving around a triangular committee structure with one peak committee forming at the vertex (sometimes referred to as the 'Board'), followed by layers of sub-committees and working groups but their deliberations with industry were

also conducted in a similar manner involving informal 'fact finding' to more formal consultation. There was therefore little difference in the ways in which the standard-setters conducted their supply and demand relationships and more importantly, the exclusive interaction they all had with their respective industries.

This study proposed that both agency and the overall structure of dominant financial powers engaging in cross-border cooperation produces the exclusivity of the transnational standards-setting environment. Agents within these settings become so engrained in the environment that having specialised relationships with stakeholders is part of the dominant culture established within these forums. These environments also reinforce the ways in which relationships between public and private actors are undertaken and as a result, both regulators and private industry actors come to be aware of their roles and expectations of behaviour. This study has found that whilst the EU regulators have influenced the way in which certain norms have formed within the standard-setting regimes, such as formalised protocols, it also finds that regulators engaging in international financial standardisation are developing their own distinct identity above and beyond that of the domestic agencies from which they originate.

Global financial standard-setting is a relatively new phenomenon in international relations, giving rise to what Slaughter (2004) has referred to as the new 'diplomacy'. The functionality of the task of producing standards has created new identities, norms, roles and behaviour in these transnational forums and these functionalities are geared towards the very exclusive interactions between regulators and industry. However, as the findings of this

study show, this interaction is not without its boundaries, which are imposed and constructed through institutional means. The institutionalised or social construction of identities, norms, roles and behaviour is difficult to support empirically but there was a very strong undercurrent evident in all three cases about identities and as a result the perception about how those identities should think and behave. This study argues that this perception was influenced largely by the European domestic institutional systems, which placed importance on hierarchical relationships and the enforcement of authority through roles and established practice. The most prevalent identity mentioned in all three cases was without a doubt the identity and role of the 'regulator', which despite having different domestic preferences, essentially meant the same thing to all regulators engaging at the international financial standardisation level.

In the case of the BCBS, one interviewee commented in no uncertain terms that "first and foremost we are regulators"²⁸². Interviews with various Members of the IAIS also reiterated that standard-setting is primarily the "business of regulators"²⁸³. Despite the fact that it was a private organisation, the IASB also believed itself to be an 'industry regulator' which for the IASB meant that it was performing a public function. One Board Member stressed that as a result of this institutional identity, "there is a real pressure on this organisation to maintain its credibility – to be seen to be acting independently, to be structured as an independent organisation – and then to

²⁸² From confidential interviews with the BCBS conducted in 2006

²⁸³ From confidential interviews with Members of the IAIS

be seen to be acting independently...and not be the hand-maiden of vested interests...”²⁸⁴

Perceptions of regulators and regulatory authority were also largely understood by private industry. There was a pre-defined expectation of the way in which regulators were going to behave and that is, conservatively. Private industry representatives were not surprised when regulators for instance disagreed with their views or disregarded them altogether. They were instead surprised when regulators behaved in the opposite fashion, when they were very accommodating or open to the idea of industry input. More telling was the comment made by a private industry representative involved with the work of the BCBS that they would have ‘little respect’ for a regulator who “tried to give their industry what they wanted”. The more important quality perceived in a regulator was “somebody who was recognised as a rigorous thinker in these issues from a regulatory point of view”²⁸⁵.

The underlying theme of these findings therefore is that the cognitive persuasion of actors is not only influenced by common and shared background beliefs and social conditioning but also more fundamentally by the norms created within institutions. Professional ‘peer pressure’ was a prevalent theme across all three cases and the desire to conform to pre-conceived notions about what certain roles should fulfil were paramount to how decision outcomes would come about. To outsiders, technical discussions may indeed be impenetrable to wider societal constituencies; but when looking from ‘within’ the organisation, there are clear demarcations

²⁸⁴ From confidential interviews with an IASB Board Member in 2006

²⁸⁵ From confidential interview with a large industry association

between technical content which can favour private interests, and technical deliberation which imposes very firm constraints.

The institutionalised construction of norms within organisations is therefore a very powerful means for actors to not only shape their interaction with other actors but to also enhance their own positions of authority and cognitive preferences. This was most clearly seen in the case of the IAIS. The very deliberate imposition of formal and informal boundaries between public regulators and private Observers played a critical role in ensuring regulators always had the final say on standards outcomes. However more inherently was its effect on the way in which, crudely speaking, private Observers were 'put in their place'. These impositions of structure were without a doubt motivated by the desire of certain regulators to uphold and maintain their status as regulators who govern, rather than regulators who negotiate and deliberate with their constituents.

These visible boundaries and constraints were also imposed and constructed in the case of the IASB. Unlike the interpersonal divisions created between identities in the IAIS, regulators and central banks constructed their own institutional barriers designed to affirm their positions of authority relative to the IASB. This was because the IASB's fair value paradigm was fundamentally diverging from the preferences of regulators. As the former General Manager of the Bank for International Settlements (BIS) noted "the development of international financial reporting standards has brought to the fore important differences in perspective between accounting standard setters on the one hand and prudential authorities on the other that will need to be reconciled. The stakes are high." (Knight 2004) As a result

filters and carve outs were first and foremost designed to show the accounting standard setter that the prerogatives of regulators outweighed the purpose and function of accounting standards.

In addition to these institutional barriers to pressure the IASB to change their standards in accordance with the interests of regulators, the regulators also emphasised the role of the IASB as a ‘macro prudential’ regulator whose interests should necessarily align with the wider imperatives of the global financial system. Malcolm Knight, former General Manager of the BIS made several public speeches to this effect, explaining that prudential and accounting standards should be “mutually consistent” to promote “a well functioning and stable financial system” (Knight 2004). This was in effect the construction of the IASB’s public role to provide not just accounting standards for its end users, but standards that ultimately served a prudential purpose. This has led to the IASB to transform its role considerably, evident in its new governance arrangements that are highly interlinked with prudential and public authorities²⁸⁶. Its mission statement is also testament to this new found role, stating that “Our mission is to develop, in the public interest, a single set of high quality, understandable and international financial reporting standards (IFRSs) for general purpose financial statements.”²⁸⁷

These findings reveal that the nature of private influence and its impact on outcomes can be fundamentally constructed (in the case of the

²⁸⁶ The IASB has recently announced new governance arrangements to ensure transparency and accountability. Refer the IASB website <http://www.iasb.org/The+organisation/Governance+and+accountability/governance+and+accountability.htm>

²⁸⁷ From IASB website <http://www.iasb.org/About+Us/International+Accounting+Standards+Board+-+About+Us.htm>

IAIS) and reconstructed (in the case of the IASB) through institutional means. Institutional practices, such as governance structures, decision rules, and processes can be consciously and strategically imposed by actors in order to enhance their own positions of power and authority and to constrain the participation and input of other parties. What does this therefore mean for the nature of private influence and the operation of private influence in global governance more generally? This study argues that we must rethink the way in which private influence is conceptualised within governance and discover the ways in which private influence interacts with institutional dynamics to create embedded and constitutive outcomes.

It has been the contention of this study to show that private influence is not something that is simply imposed on public policymakers or that private influence necessarily leads to outcomes which favour private interests. Instead, a conceptualisation of influence encapsulates the premise that private influence is evident in policy settings because it ultimately serves or fulfils a function or purpose. Private influence forms part of a mutually constitutive relationship among actors, which are above all, bound by the institutional setting that constitutes their interaction.

Interaction between public and private actors in the three cases of international standardisation therefore led to that of an 'embedded outcome' where governance results from the integration of public and private preferences and norms. This study has referred to this situation as either the public integration of private power or the market integration of public authority, where as a result, the nature of private influence can differ in accordance with these policy settings. Specifically, the public integration of

private power, evident in the case studies in the BCBS and the IAIS, has shown that whilst public regulators remain the policy and decision makers within a standards organisation, private actors play a key role in shaping the normative content of those standards through deliberation. On the other hand, the market integration of public authority, typified by the IASB, shows that whilst private actors act in policy and decision making capacities, public actors also then play a critical role in shaping the underlying normative frameworks of market standards to include public priorities and normative considerations.

These dual conceptualisations do not mean however that such embedded outcomes are not without disagreement and conflict. Embedded outcomes do not entail mutual agreement and narrow and exclusive deliberation does not necessarily entail capture. As all three cases have shown, there were continual struggles and conflicts between policymakers and private actors over the content and direction of standards. The major banking institutions were at odds with the BCBS over many issues, including the inclusion of the operational risk charge and specific issues covered under Pillar 2 for supervisors to have national discretion. This is in spite of the fact that the banks largely got their way with the inclusion of the internal models methodology in Basel II. There was certainly no agreement between the IASB and other regulators – namely the BCBS and the European Central Bank (ECB) over the fair value option in IAS39, prompting the regulators to impose their own prudential filters. In the case of the IAIS, meetings were entirely closed off to private Observers, or only partially opened, allowing

regulators to determine the core Solvency framework by the time Observers were allowed any input and deliberation.

This means that a dual functionality in the understanding of private influence in governance does not necessarily entail the preponderance of private market interests. It is the relationship between public and private actors which is, in other words, a constitutive one; that is, neither public nor private actors were able to undertake governance without the other and their actions were reinforced and constituted by the actions of the other. This was primarily due to the way in which institutions provided both the limits of their roles and what they were able to achieve as well as the normative 'roadmap' for what they could undertake in such settings.

The implication of these findings therefore is that private influence cannot be delineated from policy settings; it is not mutually exclusive and cannot simply be treated as such within an analysis of financial policymaking. The dual public integration of private power and the market integration of public authority contribute therefore to the conceptualisation of 'balance' between these two dominant forces in global governance. It does this by illustrating that it is not necessarily a numerically even paradigm (that is, one public authority balances one private authority); instead, it illustrates that 'balance' is an institutionally enmeshed 'fabric' that encapsulates both the vertical and horizontal interweaving of decision making, policy formation, deliberation and ultimately norm creation by both public and private actors within international governance.

This finding therefore helps us to place issues like ‘private authority’²⁸⁸ into some context by understanding that private authority does not occur in a vacuum but instead is closely interwoven into the wider fabric of public governance as was seen in the case of the IASB. It likewise helps us to place the activity and ‘closeness’ of private actors within the policy formation process as not necessarily detrimental lobbying but instead as a vital part of the information gathering task that public actors are called upon to conduct. It also shows us that public policymakers are not necessarily passive agents in this process but active participants who can be equally influenced by the social norms which accompany their roles within organisations.

7.2 Rethinking Influence: implications and policy considerations

Implications for understanding the global financial crisis and the ‘flaws in the system’

One of the main implications from the findings of this study is how we can now understand and place into some context the role private actors have played in producing the global financial architecture that is being blamed for contributing to the global financial crisis. We can now understand that ‘capture’ is based on a fundamental ‘supply and demand’ cycle of power capabilities, inherent in the technical complexities of finance, where regulators require specialised knowledge from the private sector. This finding helps us to understand that capture or the supply and demand of private sector capabilities in finance is based on fundamental information requirements, without which regulators would not be able to undertake their mandated policy and supervisory roles. However, most important for this

²⁸⁸ See for instance Cutler et al (1999)

study is also the finding that the supply and demand relationship between regulators and the finance industry does not always produce outcomes that benefit private interests. Interests, regardless of whether they are public or private, are still fundamentally constrained by institutional dynamics.

Another interesting implication from the study is on the respective roles of the US and the EU in producing global financial norms. ‘Cognitive capture’ is an issue that was raised during the global financial crisis, with critics highlighting that the cultural sway of Wall Street was not only to blame for the crisis in the US but also more generally across global financial policy²⁸⁹. However the findings reveal that US regulatory fragmentation marred its ability to consistently influence and dominate norms, allowing more united and organised EU policy prescriptions to influence the eventual outcome of standards. International financial standards were therefore largely influenced by the cultural and cognitive persuasions of the EU regulators, which were based on more formal and hierarchical relations with the private sector and where authority is considered to be the legislated realm of political actors.

One of the main policy implications arising from the findings of this study is the dilemma associated with the evidently limited supply of private power capabilities. A limited supply acts to bias and limit ‘choice sets’ so that policy options are inherently captured as a result. The obvious solution to this issue would be to expand supply, to broader ‘epistemic communities’, including academic ones who are interested in not only the applicability of methodologies but also their impact on broader social welfare. The problem

²⁸⁹ For instance, Underhill and Zhang (2003) and Buiter (2009)

with this is that the deliberation undertaken by these standards regimes is technically open and all who wish to provide their comments to these standards regimes are able to do so. The dilemma is that these comments are considered 'outside' the supply and demand relationship that has come to be institutionally engrained in these regimes.

The broader issues that arise from this study therefore concern accountability, legitimacy and the question of participation. As Held and Koenig-Archibugi argue, "global governance is a highly complex phenomenon in terms of participating actors, modes of operation and institutional forms" (2004: 130). To mandate specific recommendations for all forms of standard-setting regimes would be simplistic and ultimately futile given the long established patterns of exclusive interaction already considered the 'norm' by many in the financial regulatory domain. As Slaughter (2004) too argues, ultimately, it is policymakers who wish to respond seriously to criticisms who will need to formulate a solution, after verifying for themselves the scope of what is considered to be a problem in the first instance.

The global financial crisis has acted as an important impetus for leaders of the G-20 to address issues of financial governance, however they have responded with a policy action plan empowering the standards regimes to impose more stringent rules, as opposed to fundamentally reconsidering the accountability of the global standard-setting organisations²⁹⁰. This means that political leaders have deemed that these informal networks of regulators are fundamentally part of the global governance architecture, mandating them politically to deliver on producing more global regulations. The G-20

²⁹⁰ See for instance the G-20 Washington Action Plan and subsequent progress reports at http://www.g20.org/pub_communiqes.aspx

leaders have therefore considered the ‘flaws’ of the system to be related to the content of standards, rather than the more fundamental issue that underlies the delivery of these standards and that is the regulatory relationships that form part of a supply and demand chain of power.

This prompts us therefore to consider how best to enhance accountability and transparency so that their activities are “as visible as possible to legislators, interest groups and ordinary citizens by ensuring that they operate in a real or virtual public space” (Slaughter 2004: 172). Importantly, Slaughter has argued that the principle of inclusion should be brought to the fore, meaning that governance networks adopt clear criteria for participation that will be fairly applied. Based on the findings of this study, important lessons on inclusion and participation can be drawn from the case of the IAIS. The IAIS was exemplary in the way in which participation rules were clear to all who were involved in its activities. Members knew that as regulators they had clear priority over the agenda and policy development of proposals and that they had the prerogative of including private industry Observers when they saw fit, as well as the prerogative of excluding them if they deemed it inappropriate. Moreover, there were also clear rules about when and what situations were to be deemed inappropriate, so that Observers knew that decisions to exclude them were not simply at the whim of Chairpersons.

Transparent rules and guidelines were also apparent in the formal arrangements that structured Observer participation. This included seating, when Observers should be included in deliberation and how comments have then been taken on board is then distributed to Observers so they are aware

of the reasons why their comments were, or were not, noted or taken on board. This study argues too that these participation rules played a very important role in constructing social boundaries and identities that served to differentiate the prerogatives of regulators and private industry. Unlike the BCBS, these interests were considered to be separate, evident in rules mandating closed regulatory meetings. There are therefore very clear and transparent rules setting out and structuring participation, so that all who are involved are aware of their roles and responsibilities.

This very basic principle of establishing clear participation rules is proposed as an important but equally practical step that could be applied to enhance the transparency of the supply and demand relationship in place. This principle does not advocate the actors that should necessarily be involved and included, but simply emphasises the need for these regimes to clearly outline the criteria for participation. Deliberative equality is the goal, but transparency by way of formal protocols is considered the necessary step towards enlarging the limited supply of participants.

Imposing institutional checks and balances in transnational governance: insights into institutional design

An important implication of the study is the possibility that institutions can be used to socially construct or reconstruct what constitutes the 'public interest'. Whilst the findings of the study support the proposition that institutional mechanisms can be used to both enhance and constrain private power, this does not mean that institutional mechanisms for control will always ensure 'good policy', and do not guarantee that the 'right' interests are included in outcomes. However, what it does highlight is the very feasible

policy option to impose institutional checks and balances to filter, reconstruct and ultimately produce hybrid policy outcomes, or put simply, to reconstruct private influence for public purposes.

Reconstructing private influence to serve the 'public interest' is an issue that is not only interesting from an academic standpoint but seems a much more relevant issue to consider for the practical application in global governance today. The very essence of private vested influence is certainly at odds with the outcome that public goods can be produced for all relevant stakeholders, by primarily using private power to help achieve this goal. Nonetheless utilising the essence of private influence to contribute to the production of global public goods is an important policy issue to consider. Rather than looking at ways to *prevent* private actors from actively engaging in international governance circles, it seems a much more constructive endeavour instead to find ways in which the realities of public and private relationships can produce policy outcomes that can be favourable to all.

So what socially constructed elements are necessary to deliver such public goods? If we look at the empirical examples in this study, these are certainly almost all institutional elements. Interaction between public and private actors which are structured through both formal channels as well as by the creation of institutional norms which generate the 'public' cause are important areas of further policy as well as academic consideration. Formal institutional elements such as the 'Committee' structure and the corresponding decision rules such as consensus and the policy deliberation processes that follow this structure are powerful constraints when used to filter vested preferences but also to reshape them into institutionalised

preferences. Locating policy formation in various areas and involving a variety of different policy makers seems the first step in dispersing preferences and generating the initial 'institutional' preference.

Having an even spread of decision makers from different jurisdictions who are then required to come to a consensus decision is considered another crucial factor in generating an institutional preference. Consensus is certainly not a perfect science and outcomes can be generated because more powerful 'personalities' and jurisdictions can make their mark and dictate the direction of a consensus decision. It is nonetheless considered a much more reasonable solution than majority vote because in the former scenario, there is less certainty for lobbyists to target specific votes and 'personalities' are not contingent upon their respective jurisdiction. A powerful personality might not necessarily come from a powerful jurisdiction. Hence, consensus relies much more on the power of persuasion and argumentation and not simply on which vote is 'worth' more.

Furthermore, institutional preferences are also crucially guided by the norms which can be created within those institutions. One of the most powerful norms evident in all three case studies was the desire to uphold and maintain 'credibility' both at an individual level as well as at the overall institutional level. Hence, the norms that are created by institutions are thus crucial in this analysis. An institution that is guided and pressured to maintain a public and professional 'credibility' is certainly going to generate identities within those institutions who act on these designated 'roles'. Institutions can certainly undertake purposive actions to generate an institutional identity (for example, regulators who are seconded to the BCBS

know that for a designated number of years they are members of the BCBS and not simply regulators from their respective jurisdictions). Global or 'macro-enmeshment' between the vast numbers of international governance organisations has also become a crucial instigator of institutional 'peer pressure'. It becomes increasingly difficult to act upon self-interested institutional goals in a globally governed world where competing institutional preferences must also come to some sort of 'consensus'.

Overall, the findings help us to locate key institutional mechanisms that have the potential to govern and rein in private influence in global policy forums. These mechanisms are considered to be crucial substitutes for formal authority in informal transnational governance networks, which can be further enhanced and expanded through clearly demarcated protocols that set out what the broader social goal of the regimes should be, how the actors involved can contribute to this goal and as a result how organisational roles and identities can be constructed to produce standards to serve wider public prerogatives. There are therefore important examples arising from these case studies that could benefit from further scholarship into the issue of institutional design for the purpose of generating socially constructed goals.

7.3 Conclusion

This study has sought to uncover what constitutes influence in the global financial standards regimes and how it operates to affect outcomes. The findings and conclusions that support capture through the supply and demand relationship may certainly not be the normatively acceptable position, particularly in light of the detrimental role private influence has played in the global financial crisis. However, the findings also provide some

light about how private influence is able to be constrained through institutional means. What is crucial for an analysis of private influence in the future, not just in international financial standardisation but also for other issue areas involving private actors, is to incorporate the role that private actors do play into an analysis of governance. This means that private influence is not an external force or factor which is assumed to have negative normative implications for the production of policy; instead, it is to decipher the role private influence does indeed play and what goods it contributes to governance. It is also to decipher how the wider policy infrastructure is then equipped to ensure that vested interests – regardless of whether they are private or public – are constructed in line with the broader socially constructed ‘good’.

Private influence therefore should not be looked upon with analytical suspicion and conclusions should not be reached based solely on the mere presence and closeness of private actors to public actors. Rather it should be recognised as a part of the governance machinery that is well and truly reined in by a well established institutional infrastructure that acts to constrain and shape relationships in the first place. Furthermore these findings also prompt us to consider further the role that institutions themselves play in creating governance identities and as a result, the way in which governance in the ‘public’ interest can be constructed.

Appendix 1

List of interview questions for field research undertaken

A. Questions for standard setting officials

Standard-setting

1. Could you tell me the reason for why particular standards come about? (Eg do they arise because of industry and or regulators concerns?)
2. Could you please explain what the policy development process is for drafting a standard?
3. Who is responsible for drafting a standard? Where does this person/area derive their knowledge from?
4. Are there disagreements between members about the content of standards (ie the nature of the problem as well as the appropriate solution?) If so, what are these disagreements generally about?
5. How do disagreements get resolved?
6. Someone once said to me that a lot of negotiating on standards takes place in 'back room deals' – is this true and if so, to what extent?

External Consultation

1. Do you engage public consultation for the draft standards?
2. Which bodies or entities do you consult?
3. As part of this consultation, to what extent do you take into account their concerns about the possible impact of standards?
4. Have you had an issue which was very seriously contested? If so, which issue was this?
5. To what extent do the standards take into account the work of other standard-setting bodies or other international organisations?
6. Could you tell me which ones have the most impact and why?

Consultation with Private Actors

1. What are the key issues that you take into account from private actors?
2. Are some private actors more vocal than others?

3. Do you think they have a significant influence over the content of standards?
4. Some critics argue that standards reflect the interests of private actors: do you agree with this? If not, why?

Organisational dynamics

1. Does the organisation report to other bodies or organisations? If yes, to which body and what is the purpose of the reporting mechanism?
2. How and why did this reporting mechanism come about?
3. If there is no reporting mechanism, who or what has recognised the organisation to be the appropriate authority for standard-setting?
4. Could you tell me the reasons why the organisation is made up of the members that it has? Is this historical? Or has it evolved?

B. Questions to private entities

1. Can you please explain your organisation's role in international standard-setting initiatives?
2. What is your organisation's primary objective?
3. Which international standard-setters do you have a particular interest in consulting with?
4. What sort of consultations arrangements do you have with international bodies?
5. Is your correspondence both formal and informal? (for example, written correspondence as well as face to face meetings?)
6. Do standard-setting bodies consult you prior to issuing a finalised standard?
7. Do you attend drafting meetings of the standard-setters?
8. Could you tell me the reason for why particular standards come about? (Eg do they arise because of industry and or regulators concerns?)
9. To what extent do you think standard-setting bodies take your represented concerns into account?
10. If the standard is considered to negatively affect your represented interests, is there anything that you can do in order to have these amended?
11. Do you think standards achieve their intended aim? (eg financial stability)

12. Do you think standards overall negatively impact your industry? If yes, why?
13. Could you tell me the reasons why your organisation is made up of the members that it has? Is this historical? Or has it evolved?
14. Do those members generally have the same sorts of concerns or do they vary significantly?
15. If they vary, how are you able to obtain consensus on the policy positions?
16. When you personally participate in standard-setting forums (eg with other industry as well as regulatory participants) can you describe what the level of inter-personal rapport is like between participants? (eg friendly, formal, etc)

Appendix 2

Confidential List of Interviews

Case Study	Organisation	Date (Day/Month/Year)
BCBS		
Interview 1	BCBS	29/11/2006
Interview 2	BCBS	29/11/2006
Interview 3	BCBS	29/11/2006
Interview 4	ISDA	24/1/2007
Interview 5	ISDA	24/1/2007
Interview 6	Banking Association ²⁹¹	8/9/2006
Interview 7	Banking Association ²⁹²	8/3/2007
IAIS		
Interview 1	IAIS	29/11/2006
Interview 2	IAIS	29/11/2006
Interview 3	IAIS	29/11/2006
Interview 4	IAIS	29/11/2006
Interview 5	IAIS	29/11/2006
Interview 6	IAIS	29/11/2006
Interview 7	IAIS	30/11/2006
Interview 8	IAIS	13/2/2006
Interview 9	IAIS	13/2/2006
Interview 10	IAIS	25/6/2009
Interview 11	NAIC	6/3/2007
Interview 12	NAIC	6/3/2007
Interview 13	IMF	6/3/2007
Interview 14	IMF	6/3/2007
Interview 15	World Bank	7/3/2007
Interview 16	American Insurance Association	7/3/2007
IASB		
Interview 1	IASB	17/11/2006
Interview 2	ISDA	30/1/2007
Interview 3	BCBS	29/11/2006
Interview 4	IAIS	30/11/2006

²⁹¹ This international banking association did not wish to be named in any printed context.

²⁹² Ibid.

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