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Managing risks, preventing crises: A political economy account of Basel III financial regulations

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Managing risks, preventing crises: a political economy account of Basel III financial regulations

Jure Jeric



The
**Global
Economic
Governance**
Programme



Managing risks, preventing crises: a political economy account of Basel III financial regulations

Jure L. Jeric¹

Abstract

In the aftermath of global financial crisis, the Basel Committee on Banking Supervision quickly issued a new set of global standards. However, it remains puzzling *cui bono* Basel III has been shaped. Who are the key stakeholders in the regulatory process and to which extent have their geopolitical *loci* – based on political preferences, geopolitical strategic interests and geographical positions – influenced the final shape of Basel III?

This research sheds light on these questions using a tri-level (domestic, inter-state, global arena), multi-actor approach that captures the complexity of financial regulations. Looking in depth at the net stable funding ratio, capital requirements, French-German ring-fencing *lock-in devices*, and contingent convertible bonds I show that regulatory change is the product of a constellation of interests of at least two actors, whose *loci* are not necessarily homogenous.

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1. Introduction to Basel III

"Self-regulation as a way of solving all problems is finished. Laissez-faire is finished. The all-powerful market that always knows best is finished."

(Nicolas Sarkozy, the former French President, 2008)

During the financial crisis (2007-2008) the world witnessed the worst economic downturn since the 1930s (Wilson and Grant, 2012; LaBrosse et al., 2013). The stock market crashed, liquidity disappeared, job losses mounted, and credit standards tightened (Mishkin, 2012). Disastrous economic and social repercussions instantly catalysed public and policy makers' attention around financial regulatory issues (Moschella and Tsingou, 2013a; Baker, 2013). Prominent public figures – including politicians, central bankers, and regulators - promptly declared a defeat of the existing regulatory regimes. As the Turner Review acknowledges (FSA, 2009), the financial crisis has questioned the existing regulatory philosophy of efficient, rationality driven financial markets. Politicians were even more explicit in their remarks. Nicolas Sarkozy's statement, quoted above, best encapsulates the extent of public backlash (Crumley, 2008).

Mario Draghi, the President of the European Central Bank, proclaimed the shortcomings of Basel II as "one of the major factors of the crisis" (Draghi, 2008). In the aftermath of the financial crisis, the Basel Committee on Banking Supervision (hereafter: the BCBS) developed a new accord, the "Global regulatory framework for more resilient banks and banking systems" (hereafter Basel III) (BSBC, 2010b). The aim of "the single most important financial regulatory framework in a generation" (Masters et al., 2013a) has been to address weaknesses in regulatory requirements that have catalysed the disastrous effects of the worst crisis since the Great Depression in 1930s (Wolfson and Epstein, 2013). Key features of Basel III include new worldwide liquidity and leverage standards, as well as the increase in minimum capital requirements (BIS, 2009a, 2009b, 2010b, 2010c). However, there are significant jurisdictional differences in implementation of Basel III, considering the voluntary nature of this set of regulatory standards (Young and Ho Park, 2013). The differences are mostly reflected in stringency of specific rules and their fine-tuning (e.g. capital and liquidity requirements).

Technical amendments and regulatory improvements come as no surprise; however, it is vital to recognise a big shift in the public policy domain. Public scrutiny and politicians' heavy involvement in regulatory process highlight that banking regulations have emerged as a political issue, rather than being considered purely technical/legalistic. Despite the significant changes in the banking regulatory environment more generally, most analysis of Basel III to date has neglected political economy dimensions of the banking regulations, specifically the *qui bono* question.²

Just one of the examples of political drivers in the regulatory process is timing of changes. In a two-year period the BCBS managed to reach an agreement regarding Basel III, in comparison to Basel II that took almost a decade to materialise in the shape of a formal accord.

Classic theories of regulations derive their explanatory power from observing conflicting

² The key theoretical contributions are discussed in the 2b.

interests between lobbyists, who defend the interests of the banking industry, and regulators, whose main goal is to protect public interest. However, this is an over-simplification because we have to recognise and understand the complex socio-economic reality in which (banking) regulations are negotiated and implemented. More specifically, it is essential to recognise that institutional reform is the product of multiple actors operating at three levels: the domestic arena, the inter-state arena and the global arena.

Despite a prompt and globally cooperative policy reaction, it remains puzzling *cui bono* Basel III has been shaped. Who are the key stakeholders in the regulatory process and to which extent have their geopolitical *loci* – based on political preferences, geopolitical strategic interests and geographical positions - influenced the final shape of Basel III? How can the geopolitical *loci* account for cross-jurisdictional differences in implementation of the Basel III rules?

This research attempts to shed light on these questions by using a tri-level, multi-actor approach capable of capturing complexity of financial regulations. I analyse core features of Basel III, including capital buffers, contingent capital, the net stable funding ratio (hereafter: NSFR), and liquidity requirements, and show that financial regulations are not a zero-sum game but rather a product of complex power dynamics. In a nutshell, the domestic arena provides a political realm for internal power dynamics, which consequently shape national interests that are then reflected and confronted in the inter-state arena. Further, the global arena offers a political space for multiple key actors to exercise their power in order to achieve the outcome that is most closely aligned with their respective *locus*. Finally, in order for a certain regulatory change to materialise, it has to be a product of constellation of interests of actors, whose *loci* are not necessarily homogenous. In other words, despite initially heterogeneous interests and *loci*, actors are likely to pursue policies that would result in mutually beneficial outcomes.

The paper analyses power dynamics with a particular focus on geopolitical preferences of the key agents involved in the regulatory process of Basel III. Further, inspired by new empirical data, this research offers an important analysis of widely neglected segments of Basel III. I discuss the NSFR in context of financial institutions' ring fencing and Franco-German *lock in devices*. I also shed light on convertible contingent bonds as new, post-crisis developed financial assets.

This paper draws on Mattli and Woods' (2009) theory of global regulations. I argue that we need to pay particular attention to the geopolitical preferences of the 'demand side' agents, such as diverging interests of the banking industry, and the need for conceiving of 'institutional supply' as dynamic rather than static given the *modus operandi* of international regulators, who are both self-reflexive and receptive to constructive feedback. I also highlight the role of investors as key stakeholders in the regulatory process.

My tri-level approach draws on Helleiner and Pagliari's (2011) classification of three geopolitical arenas: domestic, inter-state and global, reinforcing the importance of integrating insights from all three geopolitical realms. Understanding that three arenas are complementary rather than mutually exclusive allows for a holistic account of Basel III. Further, the *loci* are intervening variables between actors and interests as they have direct impact on the interests of respective actors. In other words, very often the same group of actors with different *loci* do not have homogenous interests.

The qualitative part of research – new empirical data obtained through elite semi-structured interviews and discourse analysis – was triangulated with the secondary, quantitative data in order to verify the validity and reliability of methods employed (Newman et al., 2003; Creswell, 2003; Tashakkori and Teddlie, 2003; Lieberman, 2005; Bryman, 2006, 2007, 2008). All interviews were semi-structured. The following informants participated in the research: Adam Farkas, Executive Director of the European Banking Authority; Victoria Saporta, the Head of Prudential Policy Division Financial Stability at the Bank of England; Paul Achleitner, Chairman of Deutsche Bank; Dirk Notheis, Managing Director at Mittelstand Capital and the former CEO of Morgan Stanley Bank AG; Lisa Rabbe, the Head of Public Policy for Europe, Middle East & Africa at Credit Suisse; Georg Fahrenschon, the President of the German Savings Banks Association; Charles Haswell, the Global Head of the Financial Sector Policy at HSBC; and Richard Barfield, Director at Risk Consulting Division at PricewaterhouseCoopers.

The paper is organised as follows. The second section briefly reflects on the new requirements of Basel III and provides a critical appraisal of the current scholarly literature. The third section very briefly presents the analytical framework, a three level multi-actor approach. The fourth section employs this framework to analyse the power dynamics around Basel III. The last section concludes by suggesting future research avenues.

Two caveats are warranted. Firstly, as Basel III is still an ongoing regulatory process, this research focuses on the agenda setting, rule shaping, and implementation phases, while enforcement and compliance stages are not covered (Abbot and Snidal, 2009). Secondly, due to the socio-economic reality of the European Union and the United States being the most powerful interlocutors in global financial governance (Posner, 2009; Young, 2014), this paper focuses predominantly on Western economies, which have taken the lead in the Basel III process.

2. The need for political economy analysis of Basel III

2.1 Evolution of Basel III

The BCBS was formed in 1974 as a response to policymakers' failure to handle the liquidation of the German bank Herstatt. The aim was to provide a platform for central bankers to coordinate mutually beneficial policies. The BCBS has operated within the Bank for International Settlement, which is considered to be the world's most secretive financial institution (Lebor, 2013). The Basel Capital Accord on "International convergence of capital measurement and capital standards" (hereafter: Basel I) was signed in 1988. Considering the detrimental effects of the Latin American crisis on the G-10 banking sector, Basel I introduced capital requirements across the G-10 countries (Kapstein 1989, 1992; Simmons, 2001). The "International Convergence of Capital Measurement and Capital Standards: a Revised Framework" (hereafter: Basel II) was triggered by the East Asian crises (late 1990s), and it was finally published in 2004 (Wood, 2005; Tsingou 2008; Underhill and Zhang 2008). In the aftermath of the 2008 financial crisis, the BCBS developed Basel III, whose aim has been to address weaknesses in regulatory requirements that catalysed disastrous financial meltdown (BIS, 2009a, 2009b, 2010b, 2010c).

The initial proposals by the BCBS were published in December 2009, followed by a series of public consultations open to all key stakeholders in the regulatory process. Due to time constraints, further consultation papers on refined segments of Basel III (such as countercyclical buffers or net stable funding ratios) were issued in 2010, and some of them are still open for public discussion (BIS, 2014a). The cornerstone of the latest Basel Accord was signed in December 2010, which is a record time in comparison to the previous agreements (Basel II took seven years – from the Asian crisis until 2004 - while Basel I was negotiated for six years - from the debt crisis in Latin America until 1998). Some of the Basel III rules have already been phased in, most notably the capital requirements, while all rules should be enforced by 2019 (BIS, 2010a, 2014a, 2014b).

Basel III provides for the first time a common definition of capital. 'Common Equity Tier 1' (or CET1) capital should be comprised of common shares and retained earnings, although a leeway is given for smaller financial institutions, whose balance sheets are composed differently, presenting a much smaller systematic risk (Davis Polk, 2013). It is worth highlighting that hybrid capital is temporarily tolerated, but all financial instruments created with hybrid capital as their underlying asset should be phased out by 2019. In comparison with the previous agreements, it is interesting to highlight that Basel III leaves the Basel II risk weighted assets (hereafter: RWA) approach mostly unchanged. Basel III aims to remedy the capital issue by modifying the ratio methodology, by tightening capital requirements with a view of preferring higher quality assets, and by increasing the minimum standards (Shearman and Sterling, 2011).

As Figure 1 illustrates, the minimum ratio of common equity tier 1 to RWAs has increased from 2% to 4.5%, while the tier 1 capital to RWAs has also seen an increase from 4% to 6%. Basel III has introduced three new capital cushions, namely, *capital conservation*, *discretionary countercyclical* and *G-SIBs* buffers. The first buffer raises the minimum capital ratios by 2.5% of RWAs; while the countercyclical buffer can be imposed at the discretion of national regulators at the level of 2.5% of RWAs. The third buffer aimed at G-SIBs applies to 29 banks that have been deemed systematically important on terms defined by the FSB

(FSB, 2013). It is important to highlight that historical comparison of regulatory capital ratios are not straightforward because “the new Basel III methodologies produce ratios that are lower than historic measures” (Docherty, Viort, 2013:147).

Requirements	Under Basel II	Under Basel III
CAPITAL REQUIREMENTS		
Minimum Ratio of Common Equity to RWAs	2.00%	4.50%
Minimum Tier I capital to RWAs	4.00%	6.00%
Minimum Total Capital	8.00%	8.00%
Mandatory Capital Conservation Buffers to RWAs	None	2.50%
Discretionary Counter-cyclical buffer	None	2.50%
Buffer for G-SIBs	None	Up to 3.50%
LEVERAGE REQUIREMENTS		
Leverage Ratio	None	3.00%
LIQUIDITY REQUIREMENTS		
Minimum Liquidity Coverage Ratio (LCR)	None	Sufficient high-quality liquid assets to cover bank’s total net cash outflows over 30 days
Minimum Net Stable Funding Ratio (NSFR)	None	20-100%

Table 1 – Comparison of regulatory standards (BIS, 2009a, 2009b, 2010b, 2010c)

Basel III has also introduced leverage and liquidity requirements for the first time. As per Table 1, the leverage ratio is at the level of 3% and it will become mandatory in 2018; while distant implementation dates apply to the two liquidity measures as well: the net stable funding ratio (hereafter: NSFR) and the liquidity coverage ratio (hereafter: LCR). The phase in period for the former starts in 2018, while the disclosure requirements for the latter start next year, with a phase-in period to 2019 (BIS, 2014a). The LCR requires financial institutions to hold enough liquid assets, which can easily be liquidated in the capital markets, in order to pass 30-day stress tests. The NSFR should “reduce maturity mismatches between the asset and liability parts of the balance sheet and thereby reduce funding risk” (Shearman and Sterling, 2014:1).

At this point it is important to highlight that despite general support for more stringent regulations, all features of Basel III have been heatedly debated. Some of the most contested features are the level of the capital adequacy ratio, preserved A-IRB approach to risk weighting, and phase-in timescale for new measures (Admati and Hellwig, 2013; Lall, 2014; Jones, 2014). Financial regulations have significant impact on distributional effects, and it is essential to analyse the geopolitical *loci* of multiple stakeholders in order to understand the final outcome of Basel III.

2.2 Existing Literature: Strengths and Weaknesses

Basel III has attracted a vast amount of academic and public interest. Legal and economic scholars have predominantly focused on the short-term and long-term effects of more stringent regulations on economic growth, calibration of specific regulatory measures, and the financial impact on the banking institutions. However, there is a limited scholarship on the political dimensions of, and the power dynamics around, the most important regulatory framework since the financial crisis.

The current literature on the politics of recent financial regulation can be grouped into three broad approaches. The first school of thought views the lobbying power and monetary resources of international financial institutions as the key explanatory variable in understanding the current shape of Basel III (Lall, 2012, 2014; Admati and Hellwig, 2013). These scholars provide a careful analysis of the constellation of interests, lobbying strategies and bargaining power of financial institutions. The consensual view is that the banking lobbies have adversely impacted the regulatory changes. The banking lobbies' power is reflected in watering down of regulations and prolonging the timing of their implementation. However a common and problematic assumption is that all global banks have a uniform agenda. This overlooks the divergent geographical interests and fundamental differences in the *modus operandi* of financial institutions and their relationship with national economies. Representatives from the same global group of actors are very likely to have at least to a certain extent different country/region specific interests regarding regulation. Some of the examples are how different levels of capitalisation and financialisation of global banks impact their optimal regulatory strategies (Young and Ho Park, 2013), or attempts to install *lock in devices* when it comes to ring-fencing and the NSFR. Moreover, focusing on a limited set of actors (banking lobbies and their interactions with regulators) fails to account for important aspects of Basel III. In particular, it is vital to capture power dynamics of regulators, policy-makers, private sector entrepreneurs, lobbying groups and investors across the three arenas, which highlights heterogeneity of their interests.

There are opposing views on the extent to which financial institutions really influence regulatory outcomes, rather than just having access to the regulatory process, financial resources and technical expertise. Young's (2012) analysis clearly demonstrates that financial institutions' lobbying paid off in terms of shaping the agenda, but their access did not necessarily translate into influence over the content of the Basel Accords. In other words, although the lobby groups are certainly one of the key agents in the regulatory process, their wide participation and significant resources on some occasions remain insufficient for capturing the final shape of Basel III. The empirical analyses of divergent interests within the banking industry, different national interests and incentive structures for regulators will highlight the necessity to observe a wider set of actors and their power dynamics across the three *loci* levels.

Other scholars stress the importance of new ideas as the key catalyst of regulatory changes. According to Baker (2010, 2013), a broad macroprudential consensus has penetrated into the regulatory agenda since the financial crisis. The macroprudential regulatory system is a top-down approach to regulation that seeks to maintain financial stability through countercyclical interventions by directly influencing the commercial activities of private institutions with the aim of restraining asset price shocks. More specifically, Basel III has been informed by this new understanding of policy objectives, and, therefore, it directly

challenges the view of Fama's efficient markets (1970), the overreliance on the internal models of banks and other forms of self-regulation.

With a similar constructivist approach, Porter (2011) analyses Basel III as a case study on global cooperation and strengthening of international regulatory regimes. His research concludes that Basel III promotes public rather than private interests because new standards are being pursued in a functional mode rather than driven by nationally oriented bargains. However, this interpretation of Basel III significantly underestimates both national interests and important lobbying power of global actors.

Porter develops another account in collaboration with Campbell-Verduyn (2014) as they build on the idea of experimentalist governance (Sabel, Zeitlin, 2010). Campbell-Verduyn and Porter conclude that the informality and ongoing regulatory modifications at the BCBS are a good match for EU experimentalism "because enactment legislation further ties the two processes to one another".

Although both arguments provide important analyses of how new ideas emerge, the ideational shifts in policy discourse and *modus operandi* they advocate for seem to be overemphasised. It is not very clear how the ideas materialise and more importantly in whose interest it is to capitalise on these ideas. A successful, public-interest regulatory change is certainly more likely when new ideas provide a support for such reforms. However, that is only one of the elements of a complex regulatory equation. In other words, it is essential to identify and evaluate the power dynamics of different agents who have capitalised on those ideational changes.

When it comes to direct contributions of the comparative political economy account in comprehending Basel III, focusing on intergovernmental politics in the European Union (Howarth and Quaglia, 2013; Buckley, et al., 2012) provides a sophisticated understanding of divergent national interests that influence the final shape of the European and consequently the global regulatory agenda. The emphasis on multiple national interests within the European Union represents an important step in understanding the key stakeholders and divergent interests, but more attention has to be paid to domestic dynamics, which are equally important for depicting a full picture of regulatory changes.

There is a need to move beyond the most powerful European trio of Germany-France-UK, and analyse countries such as Switzerland and Sweden, which represent striking examples of regulatory stringency. Why have some countries progressed more in financial regulations than others? How to account for differences in the further tightening of regulations? Finally, any understanding of Basel III regulations is not complete without a thorough analysis of the interests of the United States, which is a major player in financial global governance alongside the European Union (Posner, 2009; Young, 2014).

This research builds on previous analyses and seeks to address shortcomings in the literature by adopting a three-level approach, which also takes into consideration the geopolitical identity of key actors, and ways this affects interests. The theoretical framework is a move towards a more sophisticated, tri-level, multi-actor approach that is capable of capturing the complexity of financial regulations. In other words, financial regulations are not a zero-sum game because nuanced relations and power dynamics among multiple actors significantly influence the final shape of regulations, which are almost never fully (dis)advantageous for a certain set of agents.

3. Analytical Framework: A three-level multi-actor approach to Basel III

The analytical framework is inspired by Mattli and Woods' (2009) work on the politics of global regulations that outlines broad conditions under which global rulemaking will occur: institutional supply on the one hand, and demand (information, interests - actors, and ideas) on the other. The most important elements for explaining the current shape and scope of Basel III are actors and interests. For the analysis of Basel III it is helpful to enhance the theoretical framework in two ways. First, institutional supply is not static but rather dependent or at least responsive to the dynamics of the demand side. Basel III is an ongoing regulatory process, and technocrats from the BCBS are both self-reflexive and receptive to feedback from the demand side actors. In other words, it is necessary to introduce the dynamic perspective of the supply side. Just as an illustration, the calibration of leverage ratio was initiated with a consultative version of the framework, then "Basel III's leverage ratio framework and disclosure requirements" were published in January 2014 (BIS, 2014c), whilst further amendments are possible until 2017.

Second, in addition to the equilibrium of institutional supply and demand, the final regulatory outcome will vary dependent on *loci* - political preferences, geopolitical strategic interests and geographical positions - of the various actors involved in the regulatory process, usually the demand side agents.

The classification of political arenas in regulatory governance used by Helleiner and Pagliari (2010) can be extended as a relevant categorisation of *loci*: domestic, inter-state and global. The domestic arena questions the idea of dominant national interests and seeks to identify the driving forces behind national policies. The inter-national arena is preoccupied with power dynamics among states and the extent of cooperation in the case of similar *loci*. Finally, the global arena does not focus on the power and preferences of the leading states but rather on the significance of the global context in which states interact, as well as the influence of non-state actors. Global technocrats, international institutions and the financial institutions with a global footprint (both banks and investors) are the major actors in this arena, whose interests are hardly shaped by specificities of a single country, but rather dependent on global changes.

Although observing three levels of geopolitical *loci* brings another layer of complexity to understanding regulatory changes, this helps us to capture the roots of national/regional divergences and the ways they feed back to the global political arena.

Based on the theoretical building blocks of the multiple actors, three political arenas and supply-demand model, this paper highlights that regulatory change is a product of constellation of interests of actors, whose *loci* are not necessarily homogenous. More specifically, the domestic *locus* contextualises the political realm of internal power dynamics, where national interests are shaped. The inter-state *locus* problematizes how domestically shaped interests are reflected and confronted in the inter-state arena while the *global locus* is focused on the political space where multiple key actors exercise their power with a view of achieving the optimal outcome relative to their respective interests.

The concept of *loci* emphasises the importance of distinguishing between similar groups of actors, who are very often misleadingly understood as a single unit. As it stems from the empirical analyses, the same group of actors (e.g. international financial institutions or national governments) very often do not have the same *loci*, which helps understand why their interests might be diverging. In other words, the concept of *loci* is the intervening variable between actors and interests.

The prevalent understanding of financial regulations was grounded in the over-simplified notion that one actor can predominantly influence the regulatory processes. This approach neglects the complexity of financial regulations, which are elaborated in the empirical section. This paper advocates that for a creation of any regulatory change, it has to be motivated by a constellation of interests of at least two actors, whose *loci* are often not homogenous. It is important to underscore the constellation of interests needed for a change due to multiple actors involved in the regulatory process. From the theoretical perspective, a single actor (or group of actors) can be the most prominent advocate of a certain regulatory outcome; however, in order for the change to materialise, it is necessary that one more actor has an overlapping interest.

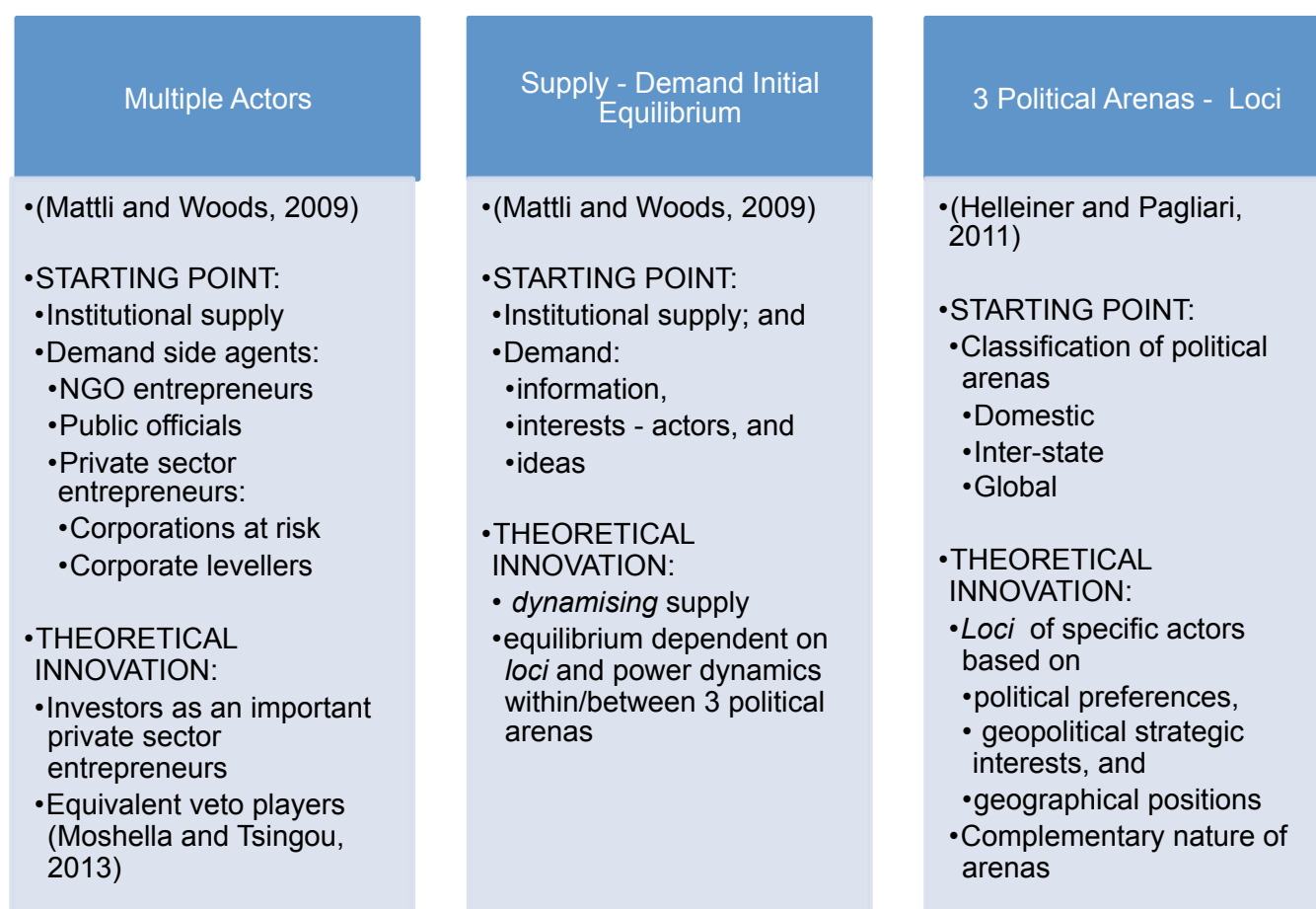


Figure 2: Analytical Framework

4. A Three-Level Multi-Actor Analysis: Who benefited from Basel III?

“Global banks are global in life and national in death”

(Sir Mervyn King, the former Governor of the Bank of England, 2009)

Locus	Actor	Interest	Regulatory Preferences
Domestic	Domestic regulators in countries where economies are heavily reliant on G-SIBs (e.g. the UK, Switzerland, the USA)	Domestic financial stability; Prevention of misconduct in the financial sector; Mitigation of possible reputational losses	Very stringent regulations (e.g. high capital requirements and additional buffers for G-SIBs)
Domestic	Domestic regulators in countries with fewer G-SIBs (e.g. Germany, France)	Domestic financial stability; Prevention of misconduct in the financial sector; Mitigation of possible reputational losses	Stringent regulations that would not compromise the competitiveness of the economy (e.g. support for cocos)
Domestic / Inter-state	The state / government officials (elected politicians and policy-makers) in economies where total bank assets' are significantly higher than national GDP (e.g. the UK, Switzerland, Sweden)	Economic growth and stability; Competitiveness of the domestic regulatory system achieved through the 'level playing field' approach	More stringent regulations (high capital requirements, introduction of the NSFR)
Domestic / Inter-state	The state / government officials (elected politicians and policy-makers) in economies where total bank assets' are at par or lower than national GDP (e.g. Germany, Italy); or the banking sector is poorly capitalised (e.g. France)	Economic growth and stability; Competitiveness of the economy	More lax regulations (not overly high capital requirements; further prolongation of the phase-in period; relaxing the NSFR)
Inter-state/Global	Regional regulators (e.g. the European Banking Authority)	Financial stability, harmonisation of standards across the region	Stringent regulations that would be applied to all member states within the specific region

Domestic / Global	Lobbying groups representing regional banks (e.g. the German Savings Banks Association)	Protection of the interests of their members	Lax regulations (e.g. differentiation of regulatory standards for different financial institutions)
Domestic/Global	Lobbying groups representing G-SIBs (e.g. the Institute of International Finance)	Protection of the interests of their members	Lax and watering down of regulations (e.g. level playing field, avoidance of regulatory arbitrage)
Global (Domestic/Inter-state)	Investors	Financial stability; High returns on investment; Transparency of the banking industry	Regulations that will achieve financial stability (as a caveat - there are also more niche investors; such as hedge funds and proprietary shops, which might have different preferences)
Global	G20, the Financial Stability Board	Resilience of the global financial system and avoidance of future disruptions	Very stringent regulations (not very precise technical details)
Global	The Bank of International Settlement - the Basel Committee	Resilience of the global financial system and avoidance of future disruptions; Mitigation of possible reputational losses; Creation of minimum standards that would apply across all markets	Very stringent regulations achieved through compromises of the main actors involved (high capital and liquidity standards)

4.1 Domestic Arena

Although the disastrous socio-political effects of the financial crisis started seven years ago, the professional and academic audiences still heatedly debate some of the fundamental features of the worst economic slowdown since the Great Depression of the 1930s (Gamble, 2009; Germain, 2012). However, Mervyn King's famous observations that "global banks are global in life and national in death" (2009) remains uncontested. The government bailouts of

some of the major national banks, such as the Royal Bank of Scotland and Lloyds in the United Kingdom (Martin, 2013), the American International Group in the USA, or the BFA Bankia in Spain (Gordon, 2012), serve as strong reminders of the dependence of national economies on the banking sector, and *vice versa*. For understanding domestic dynamics in relation to regulatory changes, it is essential to observe banking models and how they correspond to the health of national economies. A healthy and sustainable financial sector is a precondition for economic prosperity and growth (Levine, 2005; Mishkin, 2012). Thus, governments rely on regulations as a way of resolving the trade-off between having a robust financial infrastructure and the system that will catalyse money creation and growth. In other words, governments create and adopt regulatory policies with a view of balancing private and public interests (Oatley and Winecoff, 2011).

Country	Domestic GDP (\$bn)	Total Bank Assets of Publically Listed Banks (\$bn)	Total Assets % of GDP
France	2609	7660	293.60
Germany	3401	3330	97.91
Italy	2015	3170	157.32
Japan	5964	10100	169.35
Spain	1352	3910	289.20
Sweden	526	1980	376.43
Switzerland	632	3140	496.84
UK	2441	8820	361.33
USA	15685	11580	73.83

Figure 3 – Total Bank Assets as % of Domestic GDP (Bloomberg, 2014; IMF, 2014; compiled by the author)

One of the most useful measures for understanding a relationship between the banking sector and national economies is a ratio of total bank assets to domestic GDP (World Bank, 2005; Beck, et al., 2010).³ As a rule of thumb, regulatory requirements are very likely to be stricter where banks are large relative to the national economy and therefore pose higher risk for the health of economy. Governments with economies where total bank assets are significantly higher than the domestic GDP (e.g. Switzerland, Sweden and the UK, see Figure 3) are prominent advocates of more stringent regulations. Considering that Switzerland's banking assets are five times the size of the country's GDP, it comes as no surprise that the Swiss have adopted the most stringent regulations (Bono et al., 2012) or the 'super-equivalent' approach (BCBS, 2013). Domestic regulators require the Swiss banks Credit Suisse and UBS to hold capital equivalent to 19% of Basel III RWA, based on their size and market position. Of these, 10% must be common equity Tier 1 capital, while an additional 9% may include contingent capital (Swiss Commission of experts for limiting the economic risks posed by large companies, 2010). This compares with the 4.5% minimum common equity capital ratio, and 10.5% minimum total capital levels including the conservation buffer. The institutions of the similar size and global scope as Credit Suisse or

³ A banks' book value of equity over GDP can also be a useful measure (Dermine, 2000; Dermine and Schoenmaker, 2010). However, the adopted measurement is more often used both in academia and industry (see Schoenmaker and Werkhoven, 2012).

UBS would also be a subject to further at least 2.5% capital requirements, known as G-SIB buffers (FSB, 2013). Furthermore, the Swiss were the first to adopt some form of a countercyclical buffer, approved in February, which became applicable in September 2013 (SNB, 2012; SNB, 2013). Such regulatory reasoning is further supported by the fact that both major Swiss banks are at least 1.5 times bigger than total domestic GDP (UBS 175.79%, and Credit Suisse 157.12%, respectively).

A similar approach to domestic regulations has been adopted by Swedish regulators (Jones, 2011), who require Sweden's four largest banks (Nordea Bank, Skandinaviska Enskilda Banken, Svenska Handelsbanken, and Swedbank) to hold at least 10% core Tier 1 capital of their RWA, with an increase to no less than 12% by 2015 (Sveriges Riksbank, 2011). That compares with Basel III's 8% minimum total capital requirement by 2019, which should consist of minimum 6% core Tier 1 capital and 4.5% of common capital ratio. Even higher minimum standards apply to some European (and beyond) banks that are considered globally systematically important (BCBS, 2010a, 2010b, 2014a). These figures are lower than the ones for the aforementioned Swiss banks because the Swedish 'big fours' are not considered G-SIBs (FSB, 2013). Despite some domestic noises about competitive disadvantage for domestic banks, the Sveriges Riksbank (the Swedish Central Bank) pointed to investors' confidence and systemic financial stability as important factors driving the decision to enforce more stringent capital requirements (Levring and Carlstrom, 2013). At the same level of having the banking assets at least 3.5 times bigger than domestic GDP, the United Kingdom is the third European advocate for more stringent regulations, and certainly the most powerful one due to its historical role and the current financial significance of London (Walter, 2008; Mugge, 2014). Not surprisingly, as per Figure 4 two major UK banks - HSBC and Barclays - are together almost twice the size of the British GDP, 112.99% and 69.97% respectively.

More generally, highly internationalised banks have always dominated the British financial industry (Quaglia, 2014) and in light of recent government interventions, British banking system has also been well capitalised. Unlike their British counterparts, French banks have not been well capitalised as they rely more on domestic retail banking (Hanson et al, 2011), despite the fact that some of their major banks, such as BNP Paribas, Credit Agricole and Societe Generale, have a strong international presence (interview). In other words, although the French bank assets are three times larger than domestic GDP, the levels of bank capitalisation, a strong domestic presence and a reliance on national depositors make the government more lax about new regulations.

As the theoretical concept of *loci* suggests, very similar actors (e.g. domestic regulators and state/government officials) with different *loci* have heterogeneous interests when it comes to regulatory changes. At the other end of the spectrum in comparison to the British banking model is the German system (Moschella and Tsingou, 2013b). The former is usually depicted as coordinated, while the latter is liberal-market focused. More specifically, the German banking sector has been significantly less internationalised and heavily reliant on the network of savings and mutual banks. Although Germany is home to two G-SIBs - Deutsche bank and Commerzbank - their assets taken together do not account for the total amount of the German GDP. Furthermore, all publicly listed banks in Germany do not have larger assets in comparison to the total amount of GDP. In addition, there are also thousands of undercapitalised public and small local banks that provide most of the capital to small and medium enterprises (Bryant, 2012).

A major concern among German policy makers has been that an overly rapid assault on the funding of public and savings banks would squeeze the 'Mittelstand', at the key moment when these financial institutions were able to provide additional capital and liquidity to economically shaken enterprises (Hardie and Howarth, 2013). Concerned about more stringent capital requirements, the Association of German Banks published the report in which they strongly objected to the tightening of regulations at the expense of stabilising the financial sector (AGB, 2010). Their position was based on financial calculations according to which the German banks would be forced to raise at least €98 billion of new capital, and reduce debt obligations by trillions of euros if they were to meet the new requirements. As an interesting comparison, the analysis done by Barclays Capital in 2009 indicated that the ten largest German banks would need to raise more new capital than the 35 largest American financial institutions in order to comply with the more stringent requirements (Murphy et al., 2010; Jenkins and Wilson, 2010).

Even in the pre-crisis period, American banks were required to hold as much as 50% more of Tier 1 capital in comparison to the Basel minimum in order to be meet domestic regulators' informal threshold of being well capitalized. Further, the operating definition of capital was narrower in the US in comparison with various other developed economies (Oatley, Winecoff, 2012). Comparing the banking assets ratio of the most vocal European advocates for the more stringent regulations, it is necessary to highlight that American-domiciled bank assets account only for 73.83% of the USA GDP. On the other hand, the American banks have been well capitalised but the key reasons for their regulatory stand have to be traced in relation to other economies. Thus, the deeper implications of the American regulatory push are explored in the next section.

At this point it is important to highlight the key actors involved in domestic power dynamics and how their geopolitical stands influence their regulatory preferences. When it comes to the setting domestic regulatory agenda and implementing regulations, national regulators act as demand side actors. In comparison to their global counterparts in the BCBS who set the global agenda on the supply side of the theoretical model, domestic regulators are predominantly preoccupied with national dynamics and setting national regulations. If the national regulators are involved in the direct global regulatory changes as a part of the BCBS, then they can also be considered as suppliers of regulations in the global arena. However, that happens in a very limited number of cases, and it does not seem to be directly applicable to Basel III.

National regulators' preferences do not necessarily have to be based on economic growth, but rather the resilience of the financial system. In other words, regulators are in a principal-agent relationship with respective political bodies represented by policy-makers (Singer, 2004, 2007). At this point it is worth making a distinction between regulators as technocrats and experts who work in various national regulatory agencies, and elected politicians who operate as policy-makers in a larger number of policy areas. In the event of regulators' failure to maintain the resilience of the financial infrastructure, regulators will be exposed to the risk of having to step down.

Unlike government officials and policy-makers, regulators are not particularly incentivised to promote the competitiveness of domestic industry, unless a lack of competitiveness might detrimentally affect the stability of the financial sector (Oatley and Winecoff, 2012). Furthermore, reputational pressures on regulators are another set of incentives that encourage them to implement more stringent regulations (Levgyn, 2012). Apart from policy-

makers and regulators, this section highlighted a variety of financial actors: multiple corporations at risk with divergent interests (G-SIBs and mutual/savings banks; well-capitalised and undercapitalised banks), corporate levellers of the playing field, and the investors who will be discussed more broadly in the global context.

4.2 Inter-state Arena

The global financial crisis initiated in the United States and a consequent domino effect has caused tectonic changes in the financial systems across the (developed) world (Wilson and Grant, 2012; LaBrosse et al., 2013). Considering the detrimental effects of the crisis on the American economy, the public backlash has been one of the largest, so it does not come as a surprise that American policy makers have been supportive of more stringent regulations (Wilson, 2012). However, equally, if not more importantly, achieving a higher level of resilience in the financial system in the USA has been the opportunity to tighten regulations across all major financial jurisdictions. The industry groups have been forceful in their attempts to avoid possible losses for the American banking sector.

Furthermore, the American policy makers have had significant reservations with regards putting domestic firms at a competitive disadvantage by initiating the reforms in a unilateral fashion. Analysing the American geopolitical position regarding Basel III, Oatley and Winecoff (2012) draw their conclusion based on multiple analytical examples. As an illustration, Timothy Geithner, U.S. Treasury Secretary, pointed out that the American administration's goal was to raise capital ratios in such a way as to not disadvantage American firms. In other words, it was obvious that the American financial system would hardly benefit from tightening regulations in absolute terms (Wilf, 2012). However, it was in the American national interest to utilise competitive pressures in creation of the level playing field. In other words, the American banks would find the new regulatory burdens less worrisome if their competitors were also required to meet the same standards of regulatory burden as a way of avoiding international, regulatory arbitrage. Therefore, the US government has forcefully insisted on tighter capital requirements as an integral part of Basel III.

A major American ally in the tightening of regulations has been the United Kingdom (Walter, 2008; Wilson and Grant, 2012). The financial crisis hit the UK more severely than most other EU countries, highlighting the growing reliance of British economic growth upon the financial sector prior to 2008 and the massive liability that global financial institutions pose for taxpayers and voters (Howarth and Quaglia, 2013; Quaglia, 2014). Considering the great efforts of the British government in providing liquidity to domestic banks and bailing them out, all major British banks have been much more capitalised than the European ones (Masters, 2012; Docherty and Viort, 2014). Although American and British national interests have been mostly aligned, such a coalition has not been sufficient to catalyse regulatory reforms. As Posner (2009) highlights, the central role played by the US in the realm of economic governance has been challenged by the European Union. Therefore, it is essential to understand the interstate relation in Europe, whereas the UK is just one of the important players alongside Germany and France.

4.2.1 The domestic and inter-state arenas and capital requirements

As the theoretical framework suggests, in order for a regulatory change to occur it has to be a product of constellation of interests of at least two actors. Based on the previously discussed national banking infrastructure and economic models, there has been a divide between the US and the UK on the one hand, who have pushed for regulatory changes, and Germany and France on the other, which have been more oppositional towards regulatory changes (Zimmermann, 2010). The Anglo-Saxon allies have been incentivised to exercise their power over a stricter definition of capital, which would be limited to ordinary shares; overall higher capital requirements, including additional buffers; and a shorter phase-in period. The continental countries, in particular Germany and France, wanted a broader definition of capital, including hybrids, silent participation and contingent capital, which would allow lower capital requirements. The continental allies opposed the leverage ratio, asked for modification of certain aspects of the liquidity rules and wanted a longer transition period (Quaglia, 2013). It is interesting to recognise that British policy makers, which in the past had supported a neoliberal interpretation of regulation, favoured strict new rules on capital requirements (Hodson and Mabbett 2009; Moschella and Tsingou, 2013a). By contrast, French and German policy-makers called for lax rules, which is in contradiction to their market-shaping approach to financial regulation, based on the coordinated model of national economies (Quaglia, 2010, 2014). It has been in the interest of German/French banks to have more lax regulations, particularly capital requirements as a way of protecting regional banks that are facing more difficulties in meeting more stringent rules.

As the analysis of capital requirements and definitions, for a regulatory change to occur it is necessary (but not sufficient) to have a constellation of interest of at least two actors. In this case, the Anglo-Saxon allies – the government officials from economies where total banks' assets are higher than national GDP and domestic regulators from countries where the economy is heavily reliant on G-SIBs – advocated for stricter rules. In addition, regional regulators have supported their efforts. Despite strong lobbying efforts of financial institutions and the continental government officials, the Anglo-Saxon constellation broadly prevailed.

However, it is vital to recognise that the key to any regulatory changes lies in technical details. For example, many EU policy-makers, in particular the Germans, were concerned about the ban on 'hybrid' capital, which would considerably reduce the capital base of their banks that used these and similar non-equity instruments in their calculation of common equity tier 1 capital (Allen and Overy, 2013). By contrast American and British policy makers were keen to exclude hybrids from the definition of capital. Although the Anglo-Saxon allies insisted that shareholders should take the losses for hybrids rather than the government having to cover it (Quaglia, 2013), the compromise has been reached by introducing a 10-year phase out period (BCBS, 2010b). In other words, 'hybrid' capital is tolerated but the conditions of hybrid assets are stricter. However, as Docherty and Viort (2014) highlight, the exact legal and accounting mechanism of the loss absorption is not standardised, which leaves it at the discretion of the relevant domestic regulators.

One of the major differences in the implementation of Basel III between the EU and the USA is the scope of the institutions that have to comply with the new regulations. With regards to the USA, Basel III is not applicable to savings and loan holding companies (hereafter: SLHC): particularly those with a significant engagement in insurance underwriting or non-financial activities (Davis Polk, 2013). Some banks covered by Basel III final rule will have to meet tighter requirements. For example, banks with the minimum of \$10 billion balance sheet

FX exposure or \$250 billion in consolidated assets must meet higher standards, such as a countercyclical capital buffer and a supplementary leverage ratio (Getter, 2014).

Furthermore, the institutions that are considered to be G-SIBs (FSB, 2013) have to comply with the relevant legislation.

On the other hand, there is no differentiation between European banks. All 8000 European banks have to meet the same standards, while G-SIBs are subject to additional requirements. Basel III applies to internationally active banks, whereas EU legislation applies to all banks as well as investment firms in the EU (Shearman and Sterling, 2013).

Although this approach has caused many controversies and significant criticism from mutual and savings' banks, the European regulators have generally justified their position by claiming that strict numerical thresholds cannot account for differences in all European countries (interview). Many European economies are of such a limited size that their health and stability can be heavily dependent on smaller banks, whose relevance in global context is occasionally close to zero. In other words, a very small bank in the global terms can be systematically important for domestic conditions and European regulators have attempted to translate such challenge into European legislation by not allowing for any differences between financial institutions, regardless of their size and business models. Such a decision has been motivated by the regulators' tendency to create a single rulebook in the EU.

The efforts of European regulators have certainly been supported by the lobbying groups representing G-SIBs, who insisted on creation of a level-playing field in the European context. In other words, if certain financial institutions have been legally obliged to take on an additional regulatory burden, then it becomes in their interest to attempt to impose regulatory changes on all players to avoid possible arbitrage opportunities. This highlights the theoretical importance of constellation of interests of actors who certainly have heterogeneous *loci* but on this specific issue their interests have broadly overleapt.

In the empirical terms, it is important to recognise that the EU has the central role in implementing Basel III, rather than national government officials or domestic regulators, as it was the case in previous regulatory processes. This is achieved through two legislative acts, the "Capital Requirements Regulation" ("CRR") and "Capital Requirements Directive: ("CRD") (together, "CRD IV"). The CRR entered into force from January 2014 and as a regulation it is legally binding to EU member states, and it does not have to be transposed to the legal systems at the member state level (CEC 2011a, 2011b). In other words, the CRR incorporates a large portion of the Basel II, 2.5 and III framework directly into a legal instrument that applies to banks and supervisors across the EU as a whole. This superseded any pre-existing member state requirements other than in areas where national discretion has been explicitly offered in the CRR, which is very limited in scope. This is in line with EU's emphasis on creating a "single rule book". In comparison, the previous framework for Basel II had to be nationally transposed at the member state level as only the relevant directive was accepted at the EU level (Shearman and Sterling, 2013). Finally, the European Banking Authority published the Regulations, Directives and Technical Standards implementing Basel III in the EU, which are work in progress.

4.3 Global Arena

In the aftermath of the financial crisis, the G20 and the Financial Stability Board have played a pivotal role in capitalising on the public momentum and pushing for more stringent

regulations (Helleiner and Pagliari, 2011; Baker, 2014). However, the global arena represents a far more sophisticated network of actors who are trying to influence the agenda and exercise their power. Although the pre-crisis institutions have been mostly involved in the coordination of regulatory efforts, there were some attempts at institutional innovations as additional mechanisms for supporting regulatory changes. In the European context, the main institutional innovations were the establishment of the European Systemic Risk Board, and the transformation of the Lamfalussy committees into independent authorities with increased budgets and power (Quaglia, 2013). The newly created bodies are the European Banking Authority (EU Regulation No 1093/2010); the European Insurance and Occupational Pension Authority (EU Regulation No 1094/2010); and the European Securities Markets Authority (EU Regulation No 1095/2010). Their goal is to take a lead in coordination of the application of supervisory standards and promotion of stronger cooperation between national supervisors within the EU.

When it comes to Basel III, the European Banking Authority has been particularly important in the calibration of new rules, their implementation across the European Union, and the conducting of stress tests. More broadly, the EBA's aim is to ensure "effective and consistent prudential regulation and supervision across the European banking sector", with a view to maintaining financial stability and safeguarding the banking industry (EU Regulation No 1093/2010; EBA, 2014).

At this stage it is important to highlight the link between national, regional and global regulators, who are most often allies in their regulatory endeavours, although diverging geopolitical *loci* can sometimes present obstacles to a more fruitful cooperation. Most broadly, regulators' efforts can be explained through three sets of incentives. Firstly, Finnemore and Sikkink refer to 'ideational commitment', where norm entrepreneurs promote ideas because they genuinely believe in them (Finnemore and Sikkink, 1998). Secondly, reputational risks present an additional motivation for endeavouring to avoid regulatory capture (Levgyn, 2012). Thirdly and most importantly, one needs to consider their professional goals of making the financial system more resilient.

Another major set of global actors is certainly industry representatives, whose role is to protect the interests of their members. In the context of Basel III, the particularly prominent groups are: the Institute of International Finance (IIF), the International Swaps and Derivatives Association (ISDA), the European Securitization Forum (ESF), the International Capital Market Association (ICMA), the International Swaps and Derivatives Association (ISDA), and the Clearing House (CH). These groups most often lobby on behalf of major financial institutions, although this certainly does not exclude banks' endeavours to exercise their power independently in the political arena. As Figure 4 illustrates, not only do global banks represent significant national actors, but also their importance is also ever increasing in the global realm. More precisely, the 20 largest banks in the world by size of their respective total assets account for 60.22% of world GDP (Bloomberg, 2014).

Country	Bank	Bank Assets (\$bn)	Total Assets % of Domestic GDP	Total Assets % of World GDP*
France	BNP Paribas	2593	99.39	3.57
	Credit Agricole	2139	81.99	2.94
	Societe Generale	1743	66.81	2.40
Germany	Commerzbank	790	23.23	1.08
	Deutsche Bank	2254	66.27	3.10
Italy	Unicredit	1166	57.87	1.60
	Intesa Sanpaolo	864	42.88	1.19
Spain	Banco Santander	1610	119.08	2.21
Sweden	Nordea Bank	849	161.41	1.17
	Svenske Handelsbanken	365	69.39	0.50
	SEB	395	75.10	0.54
Switzerland	UBS	1111	175.79	1.52
	Credit Suisse	993	157.12	1.36
United Kingdom	Barclays	2272	93.08	3.12
	HSBC	2758	112.99	3.79
	Royal Bank of Scotland	1708	69.97	2.35
	Standard Chartered	637	26.10	0.88
United States of America	Bank of America ML	2148	13.69	2.95
	Citigroup	1895	12.08	2.60
	JP Morgan Chase & Co	2477	15.79	3.40
	Goldman Sachs Group	912	5.81	1.25
	Morgan Stanley	831	5.30	1.14
	Wells Fargo & Co	1547	9.86	2.13

Figure 4: Major global banks' total assets, bank assets to applicable national GDP, and bank assets to global GDP (Sources: Bloomberg, 2014; IMF, 2014; and official bank websites; compiled by the author)

***World GDP equals \$bn 72690.**

Although the lobbying efforts of the banking industry have been considered as the dominant agent in watering down of regulations (Lall, 2012, 2014; Admati, Hellwig, 2013), it is not clear to what extent they have exclusively managed to exercise their influence on relaxing some of the features of the Basel III. There are two sets of reasons for being cautious about conclusions about their decisive power and impact. Firstly, economic reasons stress the

importance of avoiding adverse effects on lending activities. Had Basel III been fully implemented in 2010, banks would have been forced to raise €2.9 trillion in one year to meet the liquidity standards (Porter, 2011). Thus at least part of the delay in implementation could reasonably be attributed to the need not to disrupt the global financial system too severely (Williams, 2013; Getter, 2014). Furthermore, as Wilf (2012) demonstrates in her large-N study on American financial institutions, there is statistically significant evidence against regulatory capture at the point of announcing regulations, which was reflected in firms' negative stock returns associated with Basel III regulations.

More broadly, this research highlights an important lesson that financial regulations are not a zero-sum game, but rather the final outcome depends on complex power dynamics. In other words, it would be naïve not to acknowledge the interests of such a powerful industry lobby. However, it is over-simplistic to consider Basel III solely as the product of financial institutions' power. Secondly, practical reasons are also important because some of the rules have been developed from scratch so the calibration process and quantitative impact studies require significant time resources. One example to illustrate this point is the recent amendment of counter-party credit charges for a particular asset class, which were under-calibrated by the regulators and consequently were amended after the empirical analysis had been done (interview).

4.3.1 Bank (under)capitalisation

Furthermore, the current analyses of the global regulations in general, and Basel III in particular, have widely neglected the role of investors as the key agents in regulatory processes. As different jurisdictions and even individual actors within the financial industry have to compete to attract capital, complying with non-binding regulations signals their stability and strong corporate governance.

Brummer (2011, 2012) discussed the 'disciplining' effect of market forces, which incentivises states to implement non-mandatory international financial regulations, and banks to comply with those regulations. Implementing regulations lowers the costs of borrowing and facilitates transactions with other financial institutions more easily, enhancing a bank's overall competitiveness. This is particularly the case where regulatory standards are widely implemented or viewed by the international financial community as a floor (Lyngen, 2012). These arguments mostly focus on harmonisation of regulations as the incentive for more stringent rules. However, it is equally vital to understand the importance of financial stability achieved through more stringent rules, which gives reassurance to investors.

Considering the undercapitalisation of the European continental banks (Howarth and Quaglia, 2013), it is worth highlighting that banks are dependent on investors in their equity and debt issuances so there is a significant level of competition among major banks. In response to stress tests, the European banks have raised €35.5bn in capital since July 2013, according to the research by Morgan Stanley (Thompson and Ross, 2014). Nearly €26bn of the overall amount comes through equity issuance while an additional €6bn is raised through divestments, and an extra €3.7bn from unwinding carry trades.

Morgan Stanley projects up to €60bn in total capital raising as no banks wants to fall into the trap of not passing stress tests (ibid). Banks are being forced by investors to meet new regulatory standards, even before the phase-in period (Masters, 2013a). As the theoretical framework suggests, investors have increasingly become one of the relevant actors, with

either domestic or more often global *locus*, depending on their portfolio management strategies.

If the recent calls for additional transparency in banks' reporting of Pillar 2 capital requirements materialise (Masters, 2013b), it would make it more straightforward for investors to gain deeper insights and compare bank balance sheets and consequently decide on investment calls. Therefore, investors' indirect involvement in the regulatory process will be further reinforced.

4.4 Cross-Section of Arenas

4.4.1 Contingent convertible bonds

Focusing on the most recent trend of the strong proliferation of contingent convertible bonds – *cocos* – (Pantaude, 2011) can help us understand the dynamics of different actors' interests in the geopolitical, cross-sectional regulatory realm. As per the theoretical framework, regulatory changes are motivated by a constellation of interests of at least two actors, whose *loci* are not necessarily homogenous.

In their search for return on investment, investors are increasingly investing in *cocos* as their yields are significantly higher than from the other fixed income products. Revenue of contingent convertible bonds has reached €75bn in Europe during 2013 (Thompson, 2014). There is no doubt that *cocos* are lucrative investments for investors. From the regulators' perspective, the recently developed assets help bridging the capital gap of European banks, which are still having difficulties meeting the Basel III requirements (Avdjiev et al., 2013).

The *cocos* are beneficial for the banking industries for at least two reasons: generating lucrative volume revenues and meeting capital requirements (interview). For financial institution representatives, who are preparing for the regular European Central Bank stress tests, *cocos* are the most economical way of raising capital (Calomiris and Herring, 2013). The convertible contingents cost roughly half the return on equity demanded by shareholders, and interest is tax-deductible. The financial industry has certainly pushed very hard for this instrument to be recognised as a qualifying Tier 1 capital (Docherty and Viort, 2014).

However, pure banking lobbying would hardly suffice if there were no interest from the other actors involved. In other words, different actors have formed a positive constellation of interests that has resulted in a specific regulatory outcome; in this case the introduction of *cocos*.

Furthermore, the previously discussed national divergences in levels of capitalisation (Quaglia, 2013; Hardie and Howarth, 2013) can certainly highlight that some economies – particularly the ones in the continental Europe - can benefit in relative terms more from issuances of *cocos* than other economies. This reinforces the theoretical observations according to which depending on domestic affairs, governments lobby for policies that would be most beneficial or least detrimental for their economic growth and the resilience of their respective financial systems. While the key national players drive the inter-state agenda, in the global arena there are multiple other key actors (e.g. industry groups, investors, lobbying associations, regulatory organisations), who also exercise their power in order to achieve the outcome that will be most closely aligned with specific interests. In the case of *cocos* at least

three different group of actors – financial institutions, regulators and investors – have overlapped in their interests, which has resulted in the given regulatory change.

There are a couple of important empirical lessons that reinforce the initial theoretical observations. Firstly, investors' preferences and understanding of the possible outcomes of regulations should be taken seriously as they drive not only the markets but also the regulatory processes.. Secondly, although European regulators might find some appeal in the *cocos* at the moment, in the long term their preferences might change. The *cocos* count as additional Tier 1 capital assets because they either convert to equity once a bank's pre-agreed capital threshold is triggered or simply write down the investors' principal (Avdjiev et al., 2013). However, there is growing criticism, even from inside the banking industry, that this new type of bond is extremely complex and could make a future crisis worse (Gallo, 2014). This highlights the necessity of understanding that regulators' preferences are not static and can certainly change in light of new information, as is the case already in multiple instances of calibration amendments (BIS, 2014b, 2014c).

4.4.2 Ring-fencing

Another indicative example that urges us to adopt the geopolitical, cross-sectional lens is related to the NSFR and ring fencing of financial institutions. The NSFR requires a "minimum acceptable amount of stable funding based on the liquidity characteristics of a bank's assets and activities over a one-year horizon" (Shearman and Sterling, 2014:1). However, the NSFR has received limited academic (and public) attention because it is only due to be implemented by 2018 (BIS, 2010b, 2014a).

This case study reinforces theoretical observations that domestic dynamics are reflected in inter-state power dynamics, which are further convoluted by the interests of global actors. More specifically, the continental European banks are likely to benefit in the regulatory process of ring fencing as it still remains to be seen whether the Liikanen recommendations will override national legislation.

When it is in the national or regional interest to create competitive (dis)advantages for a certain part of the industry, it is more likely that relevant regulatory measures will materialise, because for any changes to occur, it is necessary to have constellation of interests of different actors involved in the global, regulatory power dynamics. In this example, there is a constellation of interests of domestic regulators, government officials and financial institutions with the regional scope.

In September 2011, the UK's Independent Commission on Banking published the Vickers report, with a recommendation to ring fence the UK retail and trading activities of domestic banking institutions by 2019 (Independent Commission on Banking, 2011). Just over a year later, the European Commission issued the Liikanen report. The main point to take away from the report is the urgency of structural separation, with a fence being built around the trading arm (High-level Expert Group on reforming the structure of the EU banking sector, 2012). Under the Liikanen report, banks will have to comply with ring fencing if their absolute size breaches the threshold of €100 billion in trading assets, or relative volume of 15-20% of total assets.

Considering the business operations of major European banks, it is very likely that they will have to comply with the ring-fence regulations, should they become binding (Shearman and

Sullivan, 2013). In the meantime, both France and Germany have attempted to benefit from issuing their own ring-fencing plans (Thomas, 2014), which are structurally similar, but with a narrower scope in comparison to the Vickers and Liikanen reports.

In France, banking institutions will have to ring-fence their proprietary trading activities, which represents only a fraction of a typical firm's total assets (Allen and Overy, 2013). This ring-fence will also include investment and unsecured trading with hedge funds, certain high-frequency trading activities and some soft commodities trading activities. Operations within the ring-fence must be separately funded, and will have no access to insured deposits. The legislation passed through the French parliament last year, and is due to be in force by mid-2015 (Watt, 2013).

The German effort, translated into The Act on Ring-Fencing (Clifford Chance, 2013) is expected to affect around a dozen banks in the country. It also ring fences proprietary trading, and is due for implementation in mid-2015. Though the French and Germans were careful to publicly support the Liikanen report in a rare joint statement in January 2013, the wording of the statement is telling as it highlights the importance of limiting the risks associated with speculative activity, rather than the broader market-making activities Liikanen ring-fences (Joint consultation, 2013).

The key reason for the German and French *lock in devices* is the inability of their domestically domiciled banks to meet the NSFR requirements. Therefore, there has been a positive constellation of interests of domestic regulators with fewer G-SIBs, government officials in countries with undercapitalised banking sector or /and strong regional banks, and lobbying groups representing regional banks. Both French and German legislative changes would not occur if there had not been a constellation of interests from at least two different actors. For the financial institutions, new legislation allows less costly application of Basel III NSFR rules.

According to Basel III, the NSFR regulations value retail deposits particularly highly as sources of stable funding – applying a weight of 80% or 90% even to those with maturity of a year or less (BIS, 2014a). Both the Vickers and Liikanen ring fences block the trading arm from offering these products, making compliance with the NSFR extremely challenging for that side of the business. Under these circumstances, the only way to meet the NSFR standards would be for the trading arm to issue large amounts of contractual, long-dated debt, which would be very costly (Watt, 2013).

From the regulators' perspective, new legislation would be detrimental for the health of their capital markets. The government officials have been concerned about the risks of hampered economic growth as a consequence of the Vickers-Liikanen-alike ring fencing. In addition, at this point, it is worth recognising that regulators do not necessarily always have the same interests, which mirrors their background in terms of institutions or countries they monitor and supervise.

Further, in line with previous theoretical observations and empirical analyses, although the lobbying efforts of G-SIBs are usually more powerful than those of their smaller peers, the lobbying power of savings and mutual banks should not be neglected. The final regulatory outcome rather depends on the constellation of at least two actors' interests. This is a necessary condition for any regulatory change, as it has been demonstrated on the examples of capital requirements, banking sector undercapitalisation, contingent convertible bonds and ring fencing.

5. Conclusion

The aim of the research paper has been to offer nuanced empirical analyses of the political economy of Basel III, with a particular focus on the neglected variable of the geopolitical *loci*, which is an umbrella term for political preferences, geopolitical strategic interests and the geographical position of multiple stakeholders. By focusing on the geopolitical *loci* of respective actors, this research created a tri-level (domestic, inter-state, global), multi actor theoretical approach that is the most fruitful way of understanding financial regulatory complexity. Drawing on multiple features of Basel III, the research identifies and analyses the extent to which key actors, motivated by respective geopolitical *loci*, have influenced the final shape of Basel III. The adopted theoretical framework also accounts for cross-jurisdictional differences in implementation of Basel III, such as the Swiss finish, Swedish capital super-equivalence, or differentiation in national implementation based on a bank's asset size.

Further empirical contributions are a rigorous analysis of a) the convertible contingent bonds as a new financial instrument; b) the capital definitions and requirements; and c) the link between the net stable funding ratio and the most recent French-German legislative acts on ring fencing of financial institutions, which are constructed as *lock in devices*. These examples highlight an important finding: in order for a certain regulatory change to materialise it has to be a product of a constellation of interests of different actors, whose *loci* are not necessarily homogenous but do need to overlap. This theoretical observation is also supported by analysing the three *loci*, which highlights the importance of understanding a cross-section of the three geopolitical arenas.

When it comes to other theoretical contributions, the research advanced Mattli and Woods' (2009) theoretical framework by introducing the neglected concept of geopolitical preferences of the 'demand side' agents. This in turn highlighted the importance of incorporating insights from all three arenas (domestic, inter-state and global), which are complementary rather than mutually exclusive. Further, the research demonstrated the importance of *dynamising* the institutional supply of the regulatory model, as well as it introduced another key set of actors: investors.

All these contributions taken together clearly highlight the importance of cooperative communication among regulators themselves, as well as between regulators and other key actors. Increased transparency and more open forums of governance are essential in order to foster regulations that can achieve the resilience of the truly global capital markets, rather than benefit certain national or actor-specific interests. Furthermore, attempts to simplify the regulations will certainly be applauded.

At this point, it is necessary to acknowledge some of the limitations of the research. Primarily, this research could benefit from a larger follow-up study to help overcome the issues associated with sampling bias, which are somewhat inevitable due to the early phase of the project. Further, considering the complexity of Basel III, it was not possible to cover all the details of this extensive set of regulations. However, the most indicative examples were discussed in order to provide a holistic understanding of the regulatory power dynamics.

Future research would benefit from focusing more on emerging markets and developing economies, China in particular, in an attempt to understand the extent to which they contribute to financial global governance and regulatory dynamics (Posner, 2010). It still

remains to be seen how the enforcement and compliance phases (Abbot and Snidal, 2009) of Basel III will progress in order to truly materialise the new regulatory framework. Further, the European Union and the nascent Banking Union (CEC, 2014) provide a fascinating case study on financial integration, although it remains to be seen how national divergences, which have been highlighted in this research, can be reconciled in the new monetary context. More broadly, issues of cooperation in financial global governance (of regulations) represent an important intellectual challenge, and this research is a first step towards a deeper understanding of how truly globalised capital markets and financial industry can cooperate efficiently at the global level, without being jeopardised by capture-oriented actors, either national or industry-specific ones.

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