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### Banking on the public: market competition and shifting patterns of governance

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Interestingly, private sector involvement in the negotiations was initially limited. The new market structure had not yet led to a significant revision of preferences, and the proposals so far were market-friendly. The involvement of the IIF in the policymaking institutions had ensured market-based governance patterns that could even be ignored in their implementation (the CACs). As the momentum for the SDRM built, however, it quickly became clear how the policymaking institutions allowed international private sector actors to satisfy their preferences for lax governance patterns: opposition from the private sector and emerging markets led to the burying of the proposal. The private sector's opposition was strengthened by the fact that emerging markets themselves feared for their terms of competition in the market, meaning they would either lose access to capital markets or be required to pay higher spreads vis-à-vis other possible investments.

However, private sector interests are not entrenched enough to pre-empt all creditor authorities' preferences. At any rate, the problems which would have been addressed by an SDRM were unlikely to disappear. This serves to explain the acceptance (and implementation) of the CACs and the design of the private sector-led Principles. This goes to show that state actors are still influential in the age of global capital markets, even if the skewed argument pool means they share the same broad outlook on things as the private sector. The outcome of the process reflects a compromise between public sector authorities' preferences for 'economically sound' and intellectually rigorous proposals and the preferences of private sector actors to maximise leeway in order to ensure a comfortable competitive position and profits.

In summary, we see increasing internationalisation of the market being accompanied by pressures for global level, market-based governance patterns in order to deal with sovereign debt crises. Support from public actors for more stringent forms of governance is defeated in policymaking institutions with a strong position of private sector interests and a general market-oriented ideology (in other words: the yardstick for solutions is addressing 'market failures' in a way that does not interfere with market processes). The emergence of global level policymaking institutions is therefore an important explanatory factor in the emergence of 'governance light'. In practice, the governance pattern means most of the costs of sovereign debt crises are still borne by the general public in poor and emerging market countries, while creditors have considerable leverage to get repaid.

It remains to be seen, however, whether this 'governance light' can deal with possible sovereign debt restructurings in the Eurozone as a result of the current crisis. The problems of emerging market countries have suddenly come close to home in some erstwhile creditor countries. The effects of the crisis on the governance pattern for sovereign debt restructuring will be further discussed in the concluding chapter.

## Chapter 6

### Global financial governance in the wake of the crisis

This thesis started off with an anecdote about the near collapse of IKB Deutsche Industriebank in the ongoing financial crisis that began in 2007. Unfortunately, these kinds of anecdotes can be situated almost anywhere in the world: from Iceland where the entire banking sector collapsed, to the Netherlands where several banks needed state support, to Dubai where the first in what later became a longer series of sovereign debt crises occurred. Hubris went before the fall, as many iconic industry names suddenly came knocking on the state's door to obtain rescue funds.

But where the socio-economic consequences of this crisis have been severe and enduring for many people who lost homes, livelihoods or opportunities in life, at the time of writing the salary bonus bonanza has once again started at the top banks. We can safely say the benefits of global financial integration have been distributed unevenly. Yet, it is not clear whether the current crisis (the biggest economic malaise since the Great Depression) will lead to a significant reorientation of the workings of the global financial system. The relationship between the latest round of changes in the market structure and patterns of governance remains unclear. Why does it not seem possible to find a pattern of governance that mitigates the risks and effects of financial crises?

It is this concern about the instability of financial systems and their distributional impact (in good times and bad) that provided the foundation for the overarching question of this thesis: What explains the relation between market structures and patterns of governance, so as to understand the dynamics of the global financial system? This overarching question was broken down into three research questions:

1. How has the pattern of governance shifted in the two policy domains of bank capital adequacy standards and sovereign debt crisis resolution over the period 1980 - 2005? How have the relevant market structures changed over the same period?
2. What are the characteristics of the policymaking process leading to these shifts in the pattern of governance of the two policy domains in global financial governance?
3. What is the role of the policymaking process in both shifts in governance and changes in market structure? In short, how do shifting patterns of governance relate to changes in market structures?

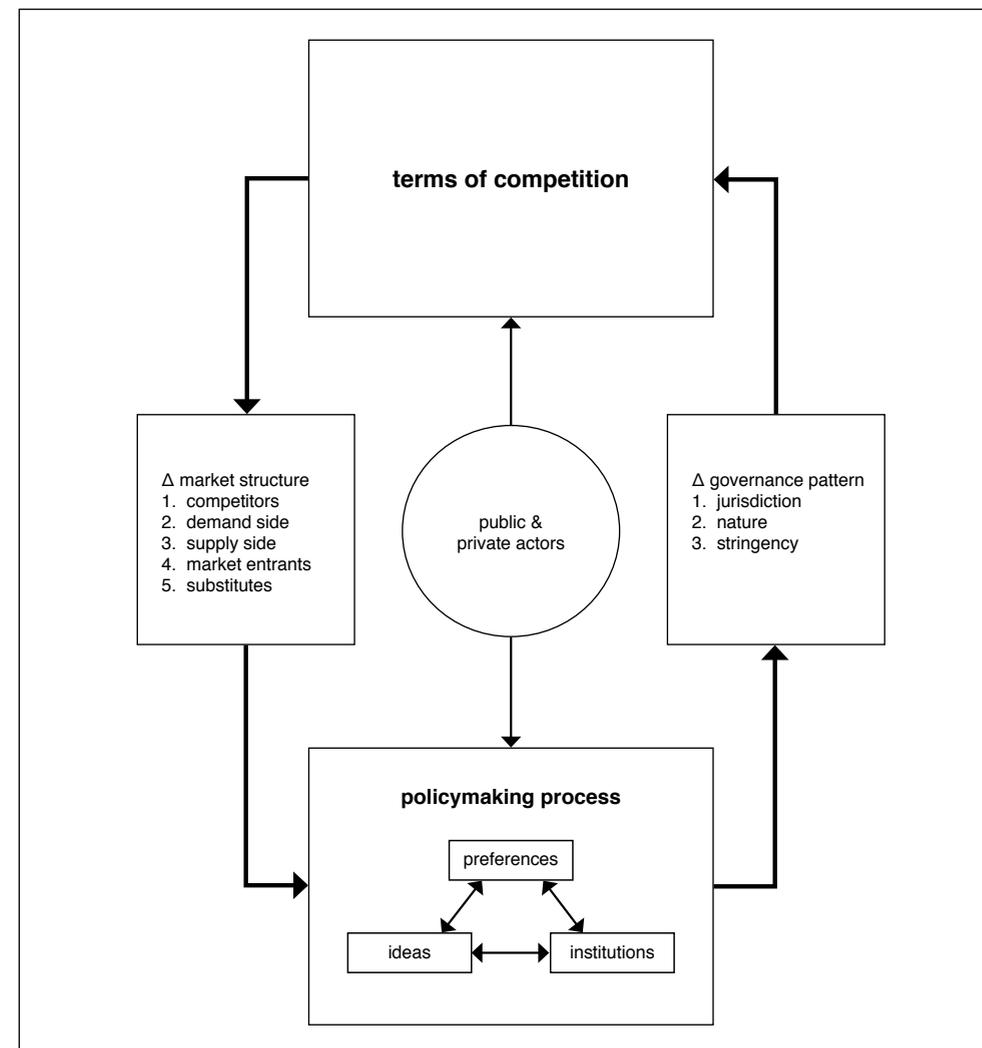
In this final chapter, the findings from the study as presented in this thesis will be summarised and the questions above will be answered. This will be the main focus of the next section, which builds on the preliminary conclusions of the two case studies to come to overarching conclusions and provide an elaboration on how these contribute to the current literature. Naturally, the turbulence since 2007 begs the question whether these conclusions have not been overtaken by current events. The second section therefore turns to the current crisis and how it has affected the policy domains of this study. It is shown that the current turmoil has to date had no significant implications for the analysis of this thesis (other than to underscore its main points). The third and final section explores the implications of the findings for IPE scholars, policymakers and – most importantly – concerned citizens.

### Global financial governance: 1980 - 2005

The research questions were addressed through two case studies: one on bank capital adequacy standards and one on sovereign debt crisis resolution. Before the conclusions that can be drawn from these case studies will be discussed, first of all the proposed linkage in this thesis between market structure and governance pattern will be reintroduced. In the second chapter a theoretical model for analysing the dynamics in these cases was advanced that works through the policymaking process. This policymaking process provides for a feedback loop between market structures and governance patterns.

The different elements of this theoretical model will be briefly reintroduced here at an analytical level; in the subsections below the actual application to the case studies will provide more ‘meat on the bones’. To graphically illustrate the theoretical model, figure 2.1 from the theoretical chapter is repeated on the next page.

Figure 6.1. The interaction between governance and market structure



To understand how the policymaking process regarding patterns of global financial governance works, the interplay between interests, ideas and institutions must be analysed. This thesis suggests a conceptualisation of this interplay where the ‘interests’ are the revealed preferences of the actors. The preferences of the actors are expressed in policymaking institutions, which in practice has the effect of excluding the expression of certain preferences from the policymaking process. This can lead to skewed argument pools and groupthink. The result is the formation of a ‘yardstick’ to measure the proposed governance patterns against that is biased towards those with access to the relevant policymaking institutions (the ideational factor).

As this thesis has shown, this integrated approach provides a fruitful avenue to analyse policy-making processes in global financial governance.

The feedback loop between market structures and governance patterns can be explained as follows. First of all, a certain market structure creates preferences of both public and private actors for (adjustments to) a governance pattern. These preferences feed into the policymaking process (as described above). As a result of this process, a new pattern of governance emerges. The shifts in governance this entails lead to a new structure of incentives for market actors (new terms of competition). By responding to these incentives in market interaction, a new market structure forms. This brings us full circle to the creation of new preferences regarding the governance pattern that follow from this (changed) market structure. Markets and governance patterns thus evolve symbiotically, not in separate domains.

The following two subsections recap how the findings of the two case studies pan out in this theoretical model. The third subsection provides an overarching viewpoint of these two case studies to come to general contributions of this study.

### *The Basel Capital Accords*

The fall of the Bretton Woods pattern of governance reinforced a trend towards increasing internationalisation of banking. The terms of competition changed, with competition more and more taking place in a global setting. This was accompanied by a reduction of capital adequacy ratios. A number of banking crises in the 1970s pointed both supervisors and banks to the importance of adequate international information sharing and standards to ensure the safety and soundness of the banking system (or in terms of the private actors: the safety and soundness of market counterparts). These preferences translated into the emergence of the BCBS, as well as the Basel Concordat codifying the division of labour between home country and host country supervisors. Furthermore, both in the context of market integration in the European Community and in the BCBS, preliminary discussions took place on the decline in capital adequacy and the importance of stopping this decline. These discussions did not yet, however, lead to a new pattern of governance.

When the Latin American debt crisis threw the low capital adequacy ratios into sharp relief, the preferences of American politicians quickly adapted in favour of stricter regulation for banks. The US private sector preferred less stringent, more market-based regulation, in part because of concern for their international competitive position. A deal was struck where the preferences for a safe and sound banking sector (which could according to theory be accomplished by capital adequacy standards) coalesced with private actor concerns for international competitiveness. Both preferences were to be met by giving the Fed the mandate to pursue international harmonisation of capital adequacy regulation.

These US preferences fed into a policymaking process that was led by US authorities, thereby consequently ensuring that decision-making took place in US-dominated policymaking institutions. Decision-making first took place in bilateral and later in trilateral negotiations.

This therefore meant the policymaking process initially excluded the expression of continental European preferences. When the negotiations moved to the policymaking institution of the BCBS, the parameters for the Basel Accord were already set. The 'yardstick' which had been established in the US-UK negotiations left only limited room for the accommodation of national idiosyncrasies of the other BCBS members.

This focus on US-dominated policymaking institutions also explains why the common yardstick to measure the solution against conformed to the preferences of the US domestic policymaking process: the safety and soundness of banks and the levelling of the international competitive playing field through risk-weighted capital standards. This yardstick was basically informed by domestic politics in the US, and because of the dominance of the US in the initial policymaking institutions it remained the yardstick in subsequent negotiations. European countries were consequently left with little room to propose a different bank capital adequacy regime or, in other words, to express strongly divergent preferences from this group norm.

The interaction between these public and private actor preferences, ideas and policymaking institutions explains why the final 1988 Basel I Accord focused on the two goals of safety and soundness of banks and levelling the international competitive playing field. The governance pattern as established under Basel I was a shift upwards on the jurisdictional dimension, as it brought the members of the G10 together under a harmonised capital adequacy standard. The nature of the Basel I governance pattern was public. Its implementation was to be achieved by national level, public bank supervisors with little room for private sector self-regulation or input. On the third dimension, Basel I was relatively stringent for banks. Its crude risk categories were not conform banks' regular economic activities and risk management.

Basel I had a significant impact on the market structure, as it gave banks the incentive to engage in regulatory arbitrage through off-balance sheet activities like securitisation. What's more, the levelling of the playing field encouraged consolidation in the banking sector and further internationalisation. At the same time, larger banks were better equipped to 'game the system' through the complex risk management systems they developed. They could deploy competitive resources in new ways, leading to advantageous terms of competition.

This changing market structure led to a simultaneous change in actor preferences with respect to the pattern of governance. The large, internationally active banks increasingly expressed a preference for using their own internal risk models, which would lead to better risk management than under Basel I. They used influential reports by global level interest associations such as the IIF and think tanks like the G30 to develop an international consensus surrounding this more risk-sensitive approach on the policymaking agenda. Supervisors maintained their preference for a safe and sound banking system but realised banks were 'gaming the system' and circumventing the safeguards of Basel I. The BCBS emerged as the policymaking institution in which these shifting preferences coalesced (for example witnessed by the landmark study into regulatory arbitrage conducted by its secretariat). This

combination of shifting preferences, emerging consensus on a new yardstick (market-based capital standards, i.e. the use of internal models) and a policymaking institution where the most important global level actors came together led to a renegotiation of Basel I.

The fact that the policymaking process took place in the BCBS as the policymaking institution led to the marginalisation of voices from outside the circle of expert financial policymakers, both in domestic politics (e.g. between ministries of finance/central banks and national parliaments and ministries of social affairs) and in the international policymaking process (other stakeholders than the financial sector itself). The discussions in this global-level policy community drew on a limited range of arguments (skewed argument pool) with a strong voice for representatives of large internationalised banks. This is also evident from the consultative papers process that was managed by the BCBS secretariat. Although seemingly offering an open and transparent policymaking process, in fact the responses to the consultative papers were heavily skewed towards private sector preferences (over 60% of responses) with less than 15% of responses coming from actors outside of the policy community of financial experts. Only incidentally did other stakeholders manage to assert their preferences, as we saw with Schröder's intervention on behalf of the *Mittelstand*.

The common outlook on the way forward that had emerged fairly quickly (the use of internal risk models to set capital adequacy standards) did not mean the public sector just gave in to private sector demands. The agenda and outcome was a genuine shared effort. On the basis of the intellectual arguments for a market-based approach – based on a narrow range of economic theory – the public actors set the goal of introducing a comprehensive risk approach. In practice, this meant for example that the public actors pushed for an operational risk capital requirement in Basel II, despite the opposition of private banks.

As with the negotiations on Basel I, it is the interaction between these specific preferences, ideas and policymaking institutions as described above that serves to explain the resultant shifts in governance from this policymaking process. These shifts had a strong bias towards the preferences of large, internationalised banks. First of all, Basel II signified a shift upward on the jurisdictional dimension to the global level. Already during the negotiations many non-G10 countries signalled their intention to implement Basel II and a special working group was established to aid in global implementation. On the second dimension of the 'nature of governance', Basel II shows a shift towards a more private nature of governance. The implementation of bank capital adequacy standards became a mixed responsibility of private actors (which run the models) and public supervisors (which check the outcomes), compared to the public implementation of the Basel I risk-weighted capital requirements. Furthermore, the ties between supervisors and banks are institutionalised under Basel II: it calls for continuous dialogue between banks and supervisors under pillar two. On the third dimension, a clear shift towards more leeway for banks is visible. Especially for banks applying the Advanced IRB approach, Basel II was less stringent.

To summarise the feedback loop in the case of bank capital adequacy standards: shifting

patterns of governance under Basel I changed the constraints actors faced in their competitive interaction in the increasingly global banking system, in turn leading to changing market structures. These changes in market structures also led to adaptation of preferences for governance of both public and private actors and led to a renegotiation of Basel I to Basel II. The negotiations on Basel II took place in a global-level policy community that exhibits characteristics of groupthink and has a strong influence of large internationalised banks. This resulted in a less stringent, global-level approach to bank capital adequacy standards, oriented towards market practices of the large internationalised banks.

### ***Governing sovereign debt crisis resolution***

In the case study of the governance of sovereign debt crisis resolution, the fall of Bretton Woods led to changing terms of competition with respect to the market for sovereign debt. It allowed states to source their funding internationally, while on the supply side it allowed banks to recycle petrodollars. Increasingly, this meant sovereign credit to emerging markets was provided by syndicates of banks. The Latin American debt crisis brought to the fore this change in market structure that had occurred during the 1970s and led to an adjustment of the preferences for governance by mainly the creditor states. The creditor states realised that instead of having 'just' their own money on the line in the negotiations (as was the case in Paris Club negotiations) now the soundness of their domestic banking system was at stake. This shifted the balance in favour of official (IMF) refinancing of debtors in order to allow bank loans to be paid and the domestic banking system to recover. However, the public sector had not yet thought this new situation through, and the private sector was not quite ready to clearly articulate coherent preferences for governance patterns. The crisis was treated as a one-off event, resulting in an ad hoc resolution of the Latin American debt crisis under the Baker and Brady plans.

The governance pattern as established under the Baker and Brady plans could be seen as a shift upwards on the jurisdictional dimension as the plans set rules guiding the sovereign debt restructuring of the emerging markets in crisis (the 17 highly indebted countries, HD17). What's more, banks affected by the governance pattern were spread all over the Western world. On the other hand, both plans were aimed at the crisis-ridden countries and their creditors only; the pattern is consequently more international than global. The nature of the governance pattern was public, developed by public authorities and implemented within the context of the IMF. For market participants, the plans were quite stringent, as they stipulated the parameters under which debt restructuring would occur. However, the plans were most stringent for debtor countries, which had to implement conditionality and had to shoulder the biggest burden of the crisis resolution. Finally, it should be noted that both plans were 'temporary' governance patterns in the sense that they were an ad hoc response to the Latin American debt crisis and as such they entailed a governance pattern that 'disappeared' after that crisis was resolved.

Especially the Brady plan had a significant impact on the market structure, as it enabled

the formation of a bond market for sovereign debts. By underwriting the securitisation of emerging market debts, creditor countries gave a strong incentive to the capital markets to provide emerging market finance. Banks at the same time were provided with an incentive through the Basel Accord to function as intermediaries rather than providing direct lending. Debtor countries seized this opportunity for new sources of financing and the share of bond debt in total sovereign debt increased rapidly. In terms of market structure, a substitute for bank financing of sovereign debt had been found in the form of capital market financing (although it likely represented a cross-sector integration in the financial system first and foremost, as banks were still heavily involved in the market for sovereign credit).

Public supervisors, notably the IMF, were quick to recognise the new coordination problems that would emerge from this new market structure according to economic theory and proposed a new pattern of governance in the form of an 'International Debt Adjustment Facility for Sovereign Debtors'. With the 1994-1995 Mexican crisis, the theory also became practice: the difficulty of resolving sovereign debt crises and the overwhelming amounts of official refinancing needed to rescue countries suddenly became clear to creditor countries. This led to a preference adjustment towards building mechanisms to deal with sovereign debt crises. Private creditors, on the other hand, favoured being left to their own devices in dealing with a debtor country in distress and negotiate a restructuring instead.

Discussions on this issue got another push with the 1997-1998 East Asian financial crisis and focused on the IMFC and G10 as the main policymaking institutions. The preferences of creditor states were consequently strongly represented and, as it turned out, the global private sector associations also had privileged access to the policymaking process. Public officials' preferences for a comprehensive, institutionalised solution in the form of an SDRM therefore clashed with private sector preferences for a market-based case-by-case approach.

As with the solution of the Latin American debt crisis, it is the interaction between these specific preferences, ideas and policymaking institutions as described above that explains the shifts in governance that resulted from this policymaking process, as well as the fact that a permanent governance pattern was now put in place. The shifts in governance were biased towards the interests of large internationalised banks, but it should be noted that the fact that a shift occurred at all was the result of public actor agency. The resulting pattern of governance in the form of CACs plus the Principles signified a shift upward on the jurisdictional dimension to the global level. A governance pattern applying to external debt of all countries was in place. On the second dimension of 'nature of governance', the CACs and Principles signified a shift towards more private types of governance compared to the Baker and Brady plans. It should be noted, however, that compared to the virtual absence of governance as per the early 1990s, it is more difficult to argue what kind of shifts occurred on this dimension. On the third dimension, a clear shift towards more leeway for banks can be discerned. Compared to the Baker and Brady plan setting the parameters for negotiation, and the SDRM possibly even enforcing these parameters, the CACs and Principles leave it up to the private sector and the

debtor states to agree on the negotiations process as well as to come to a rescheduling agreement. This offers the private sector more room for manoeuvre.

To summarise the feedback loop in the case of sovereign debt crisis resolution: shifting patterns of governance under the Brady plan changed the terms of competition in the market for sovereign credit, in turn leading to a changing market structure (in the form of capital market financing of emerging markets). These changes in market structures also led to adaptation of preferences for governance of specifically public actors and led to the emergence of new proposals for a governance pattern for sovereign debts. The negotiations on these proposals took place in a global level policy community, leading to a strong influence of large internationalised banks on the new governance pattern. This resulted in the defeat of governance proposals which would be more stringent on private actors and of a more public nature in favour of market-based patterns of governance.

### *Combining the findings in the two policy domains*

Both case studies offer opportunities to come to more general conclusions as similar trends and dynamics are visible across them. First of all, to reiterate the point one last time, both cases exhibit a feedback loop from market structure to governance pattern that was proposed in the second chapter. In other words, there is a symbiotic relationship between shifting patterns of governance and changes in market structure. In the bank capital adequacy case, Basel I contributed to the emergence of diversified and international banks with advanced risk management practices, shifting their preferences for governance towards the use of in-house risk models. Public actors adjusted their preferences as they realised that this new market structure allowed for the 'gaming' of Basel I with the associated increases in risks. In the case of sovereign debt crisis resolution, the Brady plan encouraged capital market financing of emerging markets. This diversified the preferences of private actors and led to a reduced sense of urgency to make progress on this issue. At the same time, public actors (specifically the IMF) acknowledged the potential risks and therefore proposed a comprehensive approach. In both cases, the push for renegotiation of the current governance pattern was fuelled by the costs associated with changes in the market structure.

This account of the dynamics of global financial governance contradicts the stability predicted by Historical Institutionalism and New Institutional Economics. Allowing 'exogenous shocks' like financial crises to serve as an ad hoc explanatory factor does not solve these explanatory weaknesses of HI and NIE. The shifting patterns of governance were not primarily a response to financial crises. Although crises play an important role as intermediate causes in the sense that they highlight changes in market structure that lead to readjusted preferences, the terms of competition (reflected in changes in market structure) are central. This is shown by the renegotiation of Basel I, which was not a response to a contemporary banking crisis.

A second conclusion concerns the explanation of the dynamics of both policymaking

processes. This study has shown that the outcome can be explained first of all by the constraining effects the emergence of the IMFC and BCBS as the dominant policymaking institutions had on the expression of preferences. Both the IMFC and the BCBS were skewed towards a select set of public creditor state officials (of ministries of finance and central banks) and representatives of large internationalised financial institutions. This largely excluded the expression of preferences of other stakeholders (such as organised labour). This exclusionary group exhibited the characteristics of groupthink, leading to a common yardstick to measure governance proposals against that focused on the efficient functioning of financial markets and solving market failures.

Within this already skewed argument pool, the outcome of the policymaking process reflects the contradiction between the intellectually rigorous solutions of public sector representatives (a comprehensive risk model in the case of bank capital adequacy and an SDRM in the case of sovereign debt crisis resolution) and the preferences of the private sector to maximise their leeway under the emerging governance pattern (and thus for less stringency). In both cases, this led to market-based patterns of governance that were not solely a reflection of private sector preferences (e.g. the global public standard for CACs and the inclusion of operational risk in Basel II).

## A world in turmoil: the 2007 financial crisis

As mentioned, the current financial crisis begs the questions as to whether global financial governance will witness a watershed and whether the findings on banking supervision and sovereign debt restructurings of this thesis have become obsolete. For now, this is apparently not the case. The current crisis has underscored the importance of the two policy domains taken as case studies in this thesis in the global financial system. Arguably, the response of policymakers to the crisis has focused precisely on these two policy domains. First of all a renegotiation of Basel II – which was not even fully implemented – has taken place resulting in a much-touted Basel III. Second, in response to sovereign debt stress in the Eurozone's periphery, a new debate has emerged on the proper way of governing these crises (especially in the context of monetary unions). In the following two subsections, the recent developments in the policy domains of the two case studies are briefly discussed, as well as the implications for the core arguments of this thesis. The discussion is primarily based on an analysis of *Financial Times* coverage up till April 2011 of the two policy domains.

### *Third time lucky? The negotiation of Basel III*

An important trigger of the current crisis was the failure of securitised subprime mortgages in the US. As has been demonstrated, Basel I already gave banks the incentive for off-balance sheet activities, and this incentive remained under Basel II. To a certain extent, the anticipation

of the implementation of Basel II can be credited with the change in market structure that the growth of securitised assets implied.

Basel II relied on ratings to determine the risk weights of assets (either internal ratings or ratings provided by the main credit rating agencies). As it turned out, however, the reliance on ratings to adequately assess risks in the system was unjustified. The high rating of (tranches of) securitised assets proved to be overoptimistic. This implied that the risk-weighting under Basel II was too low and the capital requirement was insufficient. In general, Basel II failed to understand adequately the risks stemming from complex financial products and securitisation.<sup>1</sup> Furthermore, the Basel II models failed to capture systemic risks that emerged over the course of the crisis (like the liquidity freeze in the interbank market). Many banks experienced liquidity problems and large amounts of direct state support and/or wider liquidity injections by central banks were needed to ensure the soundness of the global banking system. The skewed argument pool in the BCBS (biased towards the preferences of large international banks) had led to a misguided focus on market-based risk management.<sup>2</sup>

As noted above, the crisis reflected the change in market structure in the banking sector towards a cross-sector and internationally integrated banking market with an originate-to-sell business model of individual banks. The radical reordering of the market that the acute phase of the crisis implied led to a realignment of preferences of the actors involved. More importantly, it unsettled the balance of power among the different actors. Public opinion turned against the banks, which appeared to have profited handsomely from engineering this huge crisis and were now being bailed out by taxpayer money. This put political pressure on public supervisors for more stringent regulation. Supervisors themselves (not to mention banks) were also confronted with apparent flaws in the Basel II approach and the need to provide huge amounts of capital to make up for the shortfall in private institutions. Supervisors that had never been too enthusiastic about the model-based approach of Basel II – such as the Swiss – felt vindicated and saw an opportunity to break through the groupthink. The large international banks, the main voice of opposition to stringent regulation, were seemingly 'on the ropes'. These shifting preferences and balance of power prepared the ground for a new round in the policymaking process.

In the autumn of 2007, discussions mainly focused on liquidity risks, which were not (yet) addressed under Basel II. This was an issue that had already been on the BCBS' radar, and got an impetus from the credit crunch. However, some supervisors also started calling for higher capital requirements for off-balance sheet items.<sup>3</sup> This was all still within the framework of Basel II, which would not come into force until January 2008 in many countries. The IIF pleaded to avoid a knee-jerk reaction from supervisors. Regulators should take the back

<sup>1</sup> DNB, 2009, p. 30.

<sup>2</sup> As had already been pointed out by Persaud, 2000 and Danielsson, et al., 2001.

<sup>3</sup> E.g. the Governor of the Bank of Canada, David Dodge (*Financial Times*, 14 September 2007) and the Chairman of the UK FSA, Callum McCarthy (*Financial Times*, 22 October 2007).

seat while an IIF Special Committee on the Crisis would examine which response was needed. They were especially eager to avoid blanket capital increases, instead focusing on specific elements of the crisis that warranted modifications in Basel II (such as liquidity risk).<sup>4</sup>

As the crisis dragged on, in early 2008 Germany joined the push for higher capital requirements and a more stringent application of Basel II (although explicitly not asking for Basel III). Germany's Finance Minister, made it clear that if this could not be achieved at the global or European level, Germany would go it alone.<sup>5</sup> The fact that a number of German banks were caught up in the turmoil of the crisis (including IKB that required a new capital injection) no doubt contributed to this position. International momentum for more stringent capital requirements built up further when the interim report of the FSF to the G7 meeting of 9 February 2008 in Tokyo mentioned that the minimum requirements under Basel II might need to be revised.<sup>6</sup> Finally, in March 2008, US Secretary of the Treasury Hank Paulson joined the fray while outlining the US administration's response to the crisis: Basel II had to be revisited with respect to off-balance sheet exposures and liquidity risks.<sup>7</sup> This change of heart seems quite logical in light of Bear Stearns' collapse in the same month.

It was clear, however, that the underlying philosophy of Basel II was not challenged by the supervisors. The models were to be adjusted to capture the risks they had not adequately captured in advance of the crisis. Nout Wellink (president of De Nederlandsche Bank and chairman of the BCBS) argued on the eve of the IMF Spring Meetings of 2008 that Basel II was sorely needed in these times.<sup>8</sup> He was joined by former Federal Reserve President Alan Greenspan, who mounted a defence of the Basel II approach.<sup>9</sup>

During the IMF Spring Meetings the G7 ministers of finance and central bank governors had their regular meeting, and a second, special meeting with international bankers. The meeting with bankers led to irritation on the part of the public officials for the lack of accountability of the private sector: the private sector accepted some responsibility for the crisis, but at the same time pleaded for a self-regulatory approach.<sup>10</sup> This did not go down well with the G7 public officials, and it was decided that Basel II was to be modified on a number of issues. These issues corresponded to the changes in the market structure that the crisis had painfully exposed (e.g. the liquidity risk stemming from the increasing international integration of banking).

The BCBS responded swiftly, and published its first proposals only days after the IMF Spring Meeting.<sup>11</sup> Realising the inevitable, the IIF signalled it "looked forward to discuss the

BCBS proposals – mindful of the need for adjustment to requirements to be proportionate to actual risks – and underscored that these changes had to be implemented prudently, over time."<sup>12</sup>

The Swiss went even further and decided to impose a leverage ratio in the summer of 2008.<sup>13</sup> This seemed quite timely, as the October 2008 collapse of the Icelandic banking system (followed by the collapse of Iceland itself) put the spotlight on small countries with large banking systems relative to GDP. It also put pressure on the BCBS to open up the discussions on the revision of Basel II to new approaches to address risks.

In September 2008, the BCBS published its proposals on the inclusion of liquidity risk in the Basel framework.<sup>14</sup> The autumn of 2008, however, was dominated by the collapse of Lehman Brothers in September and the subsequent near meltdown of the global financial system. This led the newly appointed UK FSA Chairperson (Lord Turner) to call for a 'clean slate' with respect to capital adequacy standards in response to the crisis.<sup>15</sup>

In January 2009, the BCBS published a consultative paper outlining its proposed 'enhancements' to Basel II.<sup>16</sup> These included, for example, the liquidity risk provisions published earlier. Other important topics in these enhancements were a better modelling of the risks of securitisation, a stricter definition of what may count as capital for banks, the obligation for banks to raise capital buffers when times are good and higher capital adequacy requirements for systemically important banks. In addition, a second, simpler measure for capital adequacy was discussed: a gearing ratio (also known as a leverage ratio, a ratio of capital to balance sheet total). The Swiss initiative had paid off.

Banks, in the meantime, came under increasing pressure from markets to increase their capital (as a result of pillar three of Basel II). This also led to changing preferences among prominent bankers. Josef Ackermann, chief executive of Deutsche Bank and a high-profile IIF figure, acknowledged that 'fundamental methodological adjustments' to Basel II were necessary. He supported the idea of cyclically adjusted capital requirements.<sup>17</sup> These comments were echoed by Stephen Green, chief executive of HSBC.<sup>18</sup> As a further sign of reduced opposition by the private sector to more stringent capital requirements, attention of bankers' associations now focused on slowing down the implementation of more stringent requirements. The British Bankers Association, for example, warned regulators that implementing tougher requirements too fast could force banks to reduce lending, and thus contribute to a double dip recession.<sup>19</sup>

<sup>4</sup> Financial Times, 22 October 2007.

<sup>5</sup> Financial Times, 6 February 2008.

<sup>6</sup> FSF, 5 February 2008.

<sup>7</sup> Financial Times, 14 March 2008.

<sup>8</sup> Wellink, 10 April 2008.

<sup>9</sup> Greenspan, 17 March 2008.

<sup>10</sup> Financial Times, 14 April 2008.

<sup>11</sup> Financial Times, 17 April 2008.

<sup>12</sup> Dallara, 13 May 2008.

<sup>13</sup> Financial Times, 27 June 2008.

<sup>14</sup> BCBS, September 2008.

<sup>15</sup> Financial Times, 17 October 2008.

<sup>16</sup> BCBS, January 2009.

<sup>17</sup> Financial Times, 20 March 2009.

<sup>18</sup> Financial Times, 26 March 2009.

<sup>19</sup> Financial Times, 29 June 2009.

The crisis also had important implications for the main policymaking institutions for bank capital adequacy standards. Reflecting the rise in prominence of the G20 as the apex forum for global finance (and the rise in prominence of emerging markets in general), it was announced in June 2009 that the membership of the BCBS would be extended to all G20 members.<sup>20</sup> However, as with the BCBS negotiations on Basel II, the yardstick with respect to the emerging Basel III was already set by then. It can be doubted, therefore, that the preferences of the new BCBS members had a significant impact on the final Basel III Accord.

Soon after this extension of membership, in September 2009, the BCBS reached broad agreement on the revised Basel Accord (by now called the Basel III Capital Accord). Both capital quality and the overall level of capital would be increased and a leverage ratio would be added. It was agreed that the BCBS would make concrete proposals by the end of 2009, which could be finalised after quantitative impact studies in 2010. It was expected that the new Accord would force banks to raise significant amounts of capital.<sup>21</sup> On the other hand, supervisors took on board bankers' warnings for an adverse effect on economic recovery. It was pointed out that the tougher rules would only come into force once recovery was assured.<sup>22</sup>

In December 2009, the BCBS duly laid out a 'tougher than expected' Basel III. 'Hybrid capital' as part of tier one capital would be phased out, a leverage ratio was added, as well as a liquidity requirement that would cover a 30-day market crisis. The standards furthermore included a cyclically adjusted capital ratio, and suggested that banks would be banned from paying bonuses and dividends if capital ratios fell to low. The BCBS noted that it "will put in place appropriate phase-in measures and grandfathering arrangements for a sufficiently long period to ensure a smooth transition to the new standards."<sup>23</sup> This reflected bankers' opposition to a swift phase-in.

However, differences between various BCBS supervisors began to show. Some states had made more progress in cleaning up banks' balance sheets than others. Moreover, the use of hybrid capital was more prevalent in some countries than in others. The phasing out of hybrid capital thus proved contentious, with on the one hand the US, UK and Switzerland (which were in favour of tougher capital rules), and on the other hand Germany, France and Japan which were resentful because this measure was specifically punitive for their home country banks. The latter group was also not in favour of a strict leverage ratio.<sup>24</sup> During a June 2010 deputies G20 meeting in Busan, South Korea it became clear the rift between the two blocs could not yet be overcome. The UK and US offered a slower phase-in of Basel III in return for no tinkering with its stringency. French and German resistance was persistent, however, and focused on the inclusion of some forms of hybrid capital in tier one.<sup>25</sup>

<sup>20</sup> BCBS, 10 June 2009.

<sup>21</sup> Financial Times, 8 September 2009.

<sup>22</sup> Financial Times, 6 October 2009.

<sup>23</sup> Financial Times, 18 December 2009.

<sup>24</sup> Financial Times, 26 April 2010.

<sup>25</sup> Financial Times, 5 June 2010.

The international banking lobby pushed for an even slower phase-in of Basel III than envisaged by the BCBS. Cunningly, they pointed to demands by politicians that banks must contribute to funding the economic recovery and claimed they would not be able to do this under an 'excessive' Basel III capital requirement.<sup>26</sup> The IIF published a high-profile report arguing against a more stringent Basel III in June 2010. This widely reported study claimed that the costs of stringent regulation would be significant. Economic growth would be cut by three percentage points between 2010 and 2015, and as a result 9.7 million fewer jobs would be created. Conveniently, the analysis of the IIF did not take the costs of bailing out banks into account in their cost/benefit analysis.<sup>27</sup> The bankers' lobby's claim of an adverse economic impact was supported by the French and German business confederations, which complained that Basel III would reduce credit availability.<sup>28</sup>

The opposition of the private sector (both by bankers and the industry) was successful in paring down the most controversial proposals of Basel III. This was apparently also driven by the desire of supervisors to ensure they made the deadline of the November G20 summit in Seoul.<sup>29</sup> It seems, however, that every step back by the supervisors was not so much a step towards a compromise with the private sector, but rather an invitation for bankers to step up the pressure and further oppose certain features of Basel III. This led Sheila Bair, chairperson of the FDIC, to complain that supervisors were 'succumbing to disingenuous lobbying.'<sup>30</sup>

On 26 July, a breakthrough was achieved. All but one of the 27 BCBS members agreed to a new draft of Basel III (Germany postponed a final decision until the Seoul summit). The revised proposals appeased the bankers' lobby in several ways. For example, the leverage ratio (3 per cent of unweighted assets) would only be 'tested' until 2017, while the exact new capital requirement was still to be determined. Nevertheless, bank share prices jumped in response.<sup>31</sup> Supervisors, on the other hand, claimed that the toning down occurred because of the deteriorating economic outlook (the sovereign debt crises in the Eurozone periphery and the weak US recovery). Moreover, the pressure that the development of Basel III was under (the Seoul summit deadline) led supervisors to settle for toning down controversial elements of the Accord.<sup>32</sup>

In August 2010, the BCBS reported its own assessment of the economic impact of the new Basel III Accord.<sup>33</sup> Whether due to the toning down of the Accord or due to better measurement methods (or perhaps due to a less self-interested analysis), the predicted economic impact of the new Accord was significantly lower than that predicted by the aforementioned

<sup>26</sup> Financial Times, 12 April 2010.

<sup>27</sup> IIF, June 2010.

<sup>28</sup> Financial Times, 15 June 2010.

<sup>29</sup> Financial Times, 25 June 2010.

<sup>30</sup> Financial Times, 21 July 2010.

<sup>31</sup> Financial Times, 27 July 2010.

<sup>32</sup> Financial Times, 19 August 2010. Apparently supervisors used the 'if in doubt, cut it out' rule to speed up the process.

<sup>33</sup> BCBS, August 2010.

IIF study. Each additional percentage point capital requirement would reduce annual economic growth by only 0.04 per cent over its implementation period. This surely helped public supervisors overcome their concerns with respect to the impact on the economic recovery.

In the period running up to the BCBS governors' meeting that was supposed to put the finishing touches on the Accord, German banks made a last-ditch effort to further water down the Basel III standard. Both the Bundesverband Deutscher Banken and the Bundesverband Öffentlicher Banken Deutschlands (respectively the private and public sector bank associations) warned of the negative effects the current Basel III would have on the German economy. Especially the publicly owned banks made much use of hybrid forms of capital that would no longer be counted towards tier one under Basel III.<sup>34</sup> Several other financial actors also warned that the liquidity provisions in the draft could seriously hamper corporate credit.<sup>35</sup>

Notwithstanding the German opposition, the governors of the BCBS agreed to Basel III on 12 September 2010 (perhaps encouraged by the relatively mild effects according to the BCBS' quantitative impact study). The new Accord included an effective tier one capital requirement of 7 per cent of risk-weighted assets. Falling below 7 per cent would lead to restrictions on bonuses and dividends, with 4.5 per cent being the absolute minimum. The transition period to the new regime would last six years to 2018. In addition to this tier one ratio, a number of buffers were considered to deal with, for example, the economic cycle. In general, bankers reacted with relief. Most large international banks did not foresee too much trouble reaching the targets.<sup>36</sup> The agreement of the BCBS was formalised by the G20 summit in Seoul on 11-12 November 2010.

Several supervisors had already hinted that they consider imposing stricter rules than the Basel III Accord. The Swiss were the first to make public additional capital requirements for big banks (UBS and Credit Suisse). The UK seemed intent on following suit (which would be consistent with both country's history of topping up the Basel rules with a 'Swiss finish' or 'gold-plating').<sup>37</sup> The Swiss move was in line with a more general discussion on additional capital requirements for systemically important institutions, which is still ongoing at the time of writing.

This brief summary of the negotiations on a new pattern of governance for bank capital adequacy (which are still ongoing at the time of writing) shows how the changes in market structure that were so mercilessly highlighted by the crisis led to adjustments of actors' preferences. This was specifically the case for bank supervisors of the BCBS, but also for the (few) banks that remained purely private market actors as they were pressurised by market forces to increase capital adequacy. After Basel I and II had encouraged off-balance sheet activities and international integration, Basel III tried to mitigate some of the resulting risks. However, with

the BCBS still the main policymaking institution (although augmented by G20 supervisors halfway through the process), the general philosophy of Basel II flowed over into Basel III. This is not surprising when you consider that the BCBS had spent years building a consensus on the superiority of a market-based approach in a process of groupthink and skewed argument pools. The question as to whether the approach itself was potentially flawed and/or a cause of the crisis was not posed.

The process also shows how the need for bailouts of banks revived the close ties between bank supervisors and their domestic financial system. Especially Germany fought to protect the interests of its own banks in counting 'hybrid' capital under tier one in Basel III. This also shows how state actors simultaneously think of the terms of competition and the policymaking process: it was the public sector banks (Landesbanken) who would be most negatively affected by the exclusion of hybrid capital.

It could be noted, that just as Basel I gave an incentive for sovereign lending to OECD countries, so does Basel III provide an incentive to sovereign lending to G10 states. This incentive results from the need to build more capital, and also from the higher risk-weighted capital requirements on many other categories of lending. This certainly was not unwelcome news for G10 governments which have large funding requirements due to crisis-related expenses.

#### ***Sovereign debt crises coming home to roost: the response to sovereign debt crises in the Eurozone periphery***

After the financial sector was brought back from the brink through massive state intervention, market actors turned around and bit the hand that fed them. The economic slowdown caused by the financial crisis put the sovereign debt dynamics of a number of states in doubt (as reflected in market spreads and EU/IMF rescue packages), especially states in the Eurozone's periphery. These were soon derogatorily called PIGS (Portugal, Ireland/Italy, Greece and Spain). This has led policymakers to realise once again that 'governance light' still prevails for the orderly resolution of sovereign debts in the case of a monetary union. Whatever the specific cause of the Eurozone's periphery's problems,<sup>38</sup> the question now is not who to blame but how to solve the problem. The governance pattern for sovereign debt crises is consequently back on the agenda, which is all the more reason why it is important to understand what happened during previous phases in the policymaking process.

The outlook for the sovereign debt market initially improved with the crisis, as the credit crunch led to a 'flight to quality'. However, friction in the Eurozone started to show already in early 2008 when spreads between different Eurozone bonds started to diverge. Over the course of 2008, Credit Default Swap spreads on many Western countries rose, as these countries increased their public debts through bank rescues and stimulus packages. Again, the divergence in spreads in the Eurozone also grew. The collapse of Iceland in October 2008 put

<sup>38</sup> See Jones, 2009a, for an analysis debunking some of the popular causes.

<sup>34</sup> Financial Times, 7 September 2010.

<sup>35</sup> Financial Times, 10 September 2010.

<sup>36</sup> Financial Times, 13 September 2010.

<sup>37</sup> Financial Times, 8 October 2010.

the issue of sovereign debt dynamics front and centre, and did not improve spreads.<sup>39</sup>

Strains in sovereign funding in the Eurozone increasingly began to show, with the US and Japan benefiting from the flight to quality. Even Germany had a close call raising funds, while S&P downgraded Greece from A to A- and put Portugal and Spain on the watch list.<sup>40</sup> This led the Centre for European Policy Studies to call for the establishment of a 'European Financial Stability Fund' that would offer Eurobonds to satisfy the demand for solid European bonds.<sup>41</sup> This idea was backed by George Soros, but readily dismissed by Germany.<sup>42</sup> The ECB went even further and reminded states of the 'no bailout' clause of the Treaty of Lisbon (after Germany apparently considered ways to help debtor countries in trouble).<sup>43</sup>

As the credit crunch wore on over the course of 2009, the situation in Greece deteriorated (rising budget deficits and spreads). The EU stepped up political pressure on the Greeks to adhere to domestic adjustment to stave off a potential crisis.<sup>44</sup> Notwithstanding, in early December, Greece was further downgraded by Fitch to BBB+. Although Germany had earlier indicated it would not let a Eurozone country go bankrupt, it now indicated Greece had to find its own way out of the crisis. The Greeks increasingly desperately tried to do this, apparently by requesting sovereign funding from China through a deal with Goldman Sachs (a deal that was denied by the authorities).<sup>45</sup>

Pressured by the European Commission, Greece agreed in early February 2010 to an ambitious plan to reduce its deficit. This domestic adjustment would see an unprecedented level of EU surveillance, and did not include any official refinancing. Domestic adjustment was still thought to be sufficient to deal with the unfolding Greek drama. Private actors in the meantime increasingly turned their eye to Spain and Portugal as well and drove up their funding costs.

On 4 March, ahead of meetings of the Greek Prime Minister Papandreou with Merkel and Sarkozy, Greece threw the towel into the ring and announced it was prepared to seek IMF assistance if European support was not forthcoming.<sup>46</sup> European leaders were still very hesitant to pledge official refinancing, which caused the situation in Greece to deteriorate even further.<sup>47</sup> After a feverish weekend of negotiations, the Eurozone finance ministers announced the EU stood ready with an emergency financial support facility based on direct bilateral loans to Greece (while denying Greece needed immediate help, however). Details of the plans (and amounts) were not revealed yet.<sup>48</sup>

The details became clear after a Franco-German summit, at which Sarkozy and Merkel agreed on the terms of the financial assistance. The IMF would be involved (a German demand), and a decision to provide assistance would have to be unanimous (providing Germany with a veto). Furthermore, next to the IMF surveillance of the conditionality, the ECB and European Commission would also make assessments of adherence to the conditionality. The European agreement was specifically targeted at Greece, and in that sense did not entail durable shifts in governance.<sup>49</sup> The immediate response to the sovereign debt crisis in Greece was thus quite similar to previous episodes of crisis discussed in chapter five: official loan-based refinancing and domestic adjustment.

The agreement did not lead to an improvement in Greece's market position, yields continued to increase and its credit rating was further downgraded. During a lengthy teleconference initiated by Sarkozy on Sunday, 11 April, EU leaders agreed on a statement to provide the details of the rescue package. Merkel's initial demand of 'unsubsidised' interest rates went unheeded, with France aiming for a rate of the second-highest Eurozone borrower (4.5 per cent for Ireland and Portugal). In the end, a total of € 30 billion would be provided by the Eurozone at a 5.3 per cent interest rate (against the 7 per cent prevailing market rate).<sup>50</sup>

Despite market pressure on Greece increasing (e.g. further downgrades), the Greeks resisted for a couple of weeks (allowing the sovereign debt crisis to intensify and spill over to other Eurozone countries). At the G7 meeting in advance of the IMF Spring Meeting (22 April 2010), the US and others pushed the Eurozone to take decisive action. It was clear the combined EU/IMF rescue package of € 45 billion promised earlier to Greece did not go far enough. The G7 agreed that urgent and collective action was necessary. Later that weekend, an € 110 billion rescue package was unveiled. It consisted of € 80 billion of Eurozone loans and a € 30 billion IMF programme.<sup>51</sup> In return for the loans, the austerity package of Greece was beefed up even further (e.g. cuts in public sector salaries and pensions, a rise in value added tax and increases in alcohol, fuel and tobacco taxes).<sup>52</sup>

The rescue package did spur a debate on how to resolve sovereign debt crises. The Brussels-based think tank Bruegel called for a European variant of the SDRM.<sup>53</sup> This did not gain traction in the policymaking process, however. More support existed for the idea of a European Monetary Fund, which was supported by Germany, the European Commission and the socialist faction in the European Parliament.<sup>54</sup> However, preliminary proposals concerning 'crisis resolution' of the Commission that were leaked in May only mentioned that countries should be willing to support a country in trouble.<sup>55</sup>

<sup>49</sup> Financial Times, 26 March 2010.

<sup>50</sup> Financial Times, 15 April 2010.

<sup>51</sup> Financial Times, 11 October 2010.

<sup>52</sup> Financial Times, 3 May 2010.

<sup>53</sup> Pisani-Ferry & Sapir, 29 April 2010.

<sup>54</sup> Financial Times, 30 April 2010.

<sup>55</sup> Financial Times, 1 May 2010.

<sup>39</sup> Financial Times, 10 October 2008.

<sup>40</sup> Financial Times, 11 December 2008 and 15 January 2009.

<sup>41</sup> Gros & Micossi, 30 October 2008.

<sup>42</sup> Financial Times, 26 February 2009.

<sup>43</sup> Financial Times, 21 February 2009.

<sup>44</sup> Financial Times, 30 November 2009.

<sup>45</sup> Financial Times, 28 January 2010.

<sup>46</sup> Financial Times, 4 March 2010.

<sup>47</sup> Financial Times, 6 March 2010.

<sup>48</sup> Financial Times, 16 March 2010.

The € 110 billion rescue package did not have the effect of improving the situation in the Eurozone, rather the opposite. Pressure on Portugal and Spain increased and the sovereign debt crisis appeared to be spiralling out of control. To quell the market unrest, the Eurozone leaders, during a tense summit in the weekend of 8-9 May, committed to a € 500 billion emergency facility (€ 440 billion of debt guarantees, € 60 billion of actual balance of payments support) augmented by a € 220 billion IMF commitment. This proposal resembled the aforementioned European Monetary Fund, which would provide official financing accompanied by tough domestic adjustment in case of sovereign debt crises. It also led to a shift in governance to the regional level, or perhaps better put, a newly emerging role for the regional level (as the plan would not necessarily lead to significant shifts away from the IMF).<sup>56</sup> The facility would run for three years.

Although the facility seems a European solution, during the weekend President Obama contacted European leaders and a G7 conference call took place, all pushing the Europeans to get on with it. Germany was very much against a facility under the Commission's control, arguing its constitutional court would not agree to it. A breakthrough came from the Dutch, which proposed setting up what in effect amounted to an SPV.<sup>57</sup>

Noteworthy, the ECB also agreed to a role in the rescue efforts through the buying of sovereign bonds. Sarkozy, Berlusconi and other Southern European prime ministers had called on the ECB to do this, while Merkel, the Netherlands and Finland strongly supported the independence of the ECB. Although Trichet had, of course, considered the option, he was adamant he would not be pushed by politicians and hence would not openly commit to a bond-buying programme until the leaders had reached agreement. The eventual decision of the ECB to indeed start buying bonds caused a rare public argument in its governing council. The president of the Bundesbank, Axel Weber, publicly criticised the move. However, the ECB governing council had agreed to the bond purchases with an overwhelming majority and so the programme was implemented as planned.<sup>58</sup> From now on, the ECB would be an even more important player in crisis resolution discussions: not only as a prominent public actor, it now also had a role as a market actor owning large chunks of Eurozone debts.

The initial positive effect of the rescue package on market prices declined after a few days. There were continuing concerns about the growth prospects of Spain and Portugal under their austerity programmes, while at the same time investors wanted proof of the countries' ability to deliver. The facility did lead to a reduction of the bond yield spreads between Germany and the PIGS. Given that most investors admitted they were not buying, it seems the narrowing of the spread was due to ECB demand.<sup>59</sup>

<sup>56</sup> Financial Times, 10 May 2010.

<sup>57</sup> Financial Times, 11 October 2010.

<sup>58</sup> Financial Times, 11 October 2010.

<sup>59</sup> Financial Times, 18 May 2010.

The US pushed the Europeans to proceed with their 750 billion rescue facility as a way to stop market unrest. They were unhappy with the – in their view – tardy European response. The general approach of official refinancing combined with domestic adjustment was not put into question, however.<sup>60</sup>

In the meantime, the facility's details were being worked out in preparation for the EU summit of 17 June. The facility would become the 'European Financial Stability Facility' (EFSF) and would be led by the German former head of the Economic and Financial Affairs Division of the European Commission, Klaus Regling. It would be set up for three years (at German insistence) and be headquartered in Luxembourg. European leaders hoped their guarantees would be enough for a triple A rating, which the EFSF could use to emit bonds to finance its balance of payments support. Members would have to negotiate a memorandum of understanding with the Commission to ensure conditionality (domestic adjustment).<sup>61</sup> Of course, the co-financing with the IMF would also ensure domestic adjustment through IMF conditionality. In other words, official refinancing accompanied by domestic adjustment (the fiscal consolidation requirements imposed on the rescue funds) is still the combination of choice.

With the EFSF, the European banking sector's troubles had not ended. It was unclear how badly the banks would be hit by a potential default of Greece (or one of the other PIGS for that matter). At the same time, attention focused on Spain, which seemed destined to follow the same path as Greece. Eurozone governments, led by Germany, put pressure on Spain to come up with ambitious domestic adjustments. It was even leaked to the press that Spain might apply for funding from the EFSF, which did not sit well with the Spanish. Meanwhile, US Secretary of the Treasury Geithner had used a European tour to push for stress tests in the banking sector. These had worked well in the US, by clearing up the uncertainty surrounding banks' positions. Seemingly in retaliation for Germany's pressure on Spain (Germany was speculated to be the source of the rumours about Spain applying for EFSF funding), Spain unilaterally announced it would publish the results of the stress tests. Grudgingly, the other Europeans followed, with especially Germany in the limelight as the *Landesbanken* were likely to be in bad shape.<sup>62</sup>

Rumours began to surface in July that Germany was considering a mechanism to promote the orderly restructuring of sovereign debts.<sup>63</sup> Moreover, the EFSF did not stop sovereign debt problems from spreading in Europe. In response to the weak market outlook – compounded by fears of an adverse impact of the Basel II rules – the ECB stepped up its buying of bonds in early September.<sup>64</sup>

<sup>60</sup> Financial Times, 27 May 2010.

<sup>61</sup> Financial Times, 17 June 2010.

<sup>62</sup> Financial Times, 26 July 2010.

<sup>63</sup> Financial Times, 14 July 2010.

<sup>64</sup> Financial Times, 9 September 2010.

Tommaso Padoa-Schioppa, a respected financial policymaker and at the time president of the Notre Europe think tank, was the first to plead for a permanent EFSF.<sup>65</sup> This would mark a permanent new pattern of governance for sovereign debt crises in the Eurozone.

In October the broad contours of the German plans with respect to crisis resolution surfaced. A permanent mechanism should be set up to ensure private sector involvement in crisis resolution. In case of a sovereign debt crisis, the private sector would have to endure a haircut, although it was not yet clear how this would be enforced (the other side of the coin was that there would be a much more stringent governance pattern with respect to member states' fiscal balances).<sup>66</sup> The French struck a deal with Germany in which the 'preventive' side of the coin (stringency on fiscal balances) was traded for a permanent mechanism. France opposed the private sector bail-in, however. The UK indicated it was willing to consider limited amendments to provide for a permanent EFSF, although it would not agree to a transfer of power from Westminster to Brussels.<sup>67</sup> Smaller European states were initially mainly annoyed at this old-fashioned Franco-German power play, but eventually agreed to it. The ECB was vocal with warnings of the adverse market impact.

The response in the market to the possible private sector involvement was indeed adverse: bond yields for Ireland, Greece, Portugal and Spain rose. Interestingly, there seemed to be little outright opposition to the plans, possibly also because they were still lacking in detail.<sup>68</sup> In the weeks to follow, the outlook for the Eurozone's periphery economies deteriorated, especially for Ireland. This forced the Eurozone leaders at the G20 summit in Seoul on 11-12 November 2010 to issue a statement reiterating that the proposals for a governance pattern for sovereign debt crises would not apply to currently outstanding debt.<sup>69</sup> It also led more and more European leaders to air their resentment of the German push for a mechanism, claiming it also pushed the Eurozone to the brink of default.<sup>70</sup> A claim that ultimately proved to be accurate, as Ireland entered into rescue talks with the EU and IMF in late November.

However, Merkel was not to be deterred. On 29 November 2010, France and Germany reached a deal that was supported by the ECB and European Commission. The plan was developed in close cooperation with Herman van Rompuy (chairperson of the European Council) and Jean-Claude Juncker (Prime Minister of Luxembourg and chair of the Eurogroup). The EFSF would get a permanent replacement in 2013 in the form of a European Stabilisation Mechanism (ESM). Access to this Fund was to be accompanied by tough conditionality. New bonds from Eurozone governments would have to include CACs. The inclusion of CACs instead of 'automatic' haircuts was the result of French resistance to such automaticity. Where the plan in first instance saw no role for debt restructurings, the ESM did leave open the

<sup>65</sup> Padoa-Schioppa, 28 September 2010.

<sup>66</sup> Financial Times, 8 October 2010.

<sup>67</sup> Financial Times, 20 October 2010.

<sup>68</sup> Financial Times, 2 November 2010.

<sup>69</sup> Financial Times, 13 November 2010.

<sup>70</sup> Financial Times, 17 November 2010.

possibility of standstills and haircuts as a condition to further assistance if debt burdens were deemed unsustainable by IMF, ECB and the Commission. However, several officials (especially the ECB and in France) indicated the ESM's procedures in respect of sovereign debt restructurings did not differ from those of the IMF.<sup>71</sup>

Just days after the agreement on the ESM, Ireland was the second country to turn to the EFSF and IMF for a € 85 billion rescue programme. Furthermore, Juncker and Italy's Economy and Finance Minister Giulio Tremonti launched a plan to emit Euro-wide bonds ('E-bonds') by a European Debt Agency. This facility could, in exceptional circumstances, provide in the financing needs of countries with impaired access to debt markets.<sup>72</sup> As before, Germany was quick to dismiss these plans. Private actors differed in their view on the desirability of E-bonds.<sup>73</sup> On Thursday, 16 December 2010 the European Council approved an amendment to EU treaties to create the ESM. Officials from Germany, Finland, the Netherlands and Sweden insisted that the EU should underscore the need for domestic adjustment in the periphery. The idea of E-bonds was not adopted.<sup>74</sup>

The ESM deal determined the future governance pattern in the Eurozone with respect to sovereign debt crisis resolution (starting in 2013), with the EFSF functioning as the governance pattern for immediate sovereign debt problems. And problems there were plenty; the Eurozone debt crisis has continued to claim victims (Portugal) and necessitated additional rescue packages. Surprisingly, the IMF has been conspicuously absent when more structural solutions to the Eurozone's debt crisis (e.g. the return of the SDRM proposal) were being discussed in relevant policy forums (e.g. Ecofin). Many actors did return to the fore with their proposals, including professor Kenen with his International Debt Discount Corporation proposal of 1983.<sup>75</sup> Nevertheless, the response to the crisis resembles the response to the Latin American debt crisis: official refinancing and domestic adjustment.

The policymaking process on the Eurozone's crisis seems to mimic the global-level responses to sovereign debt crises closely, and leading to a regional version of the IMF in the form of the ESM. This can likely be explained by the fact that the process continues to be strongly informed by market opinion of the developments, and consequently conforms with the broad market-based outlook of global financial governance – also within the EU. As a result, the burden of adjustment remains at the debtor countries, and no new mechanisms for the orderly resolution of sovereign debt crisis are seriously discussed.

<sup>71</sup> Financial Times, 29 November 2010.

<sup>72</sup> Juncker & Tremonti, 6 December 2010. This suggestion had been put forward by several academics, e.g. Jones, 2010.

<sup>73</sup> Financial Times, 7 December 2010.

<sup>74</sup> Financial Times, 17 December 2010.

<sup>75</sup> Kenen, 11 February 2011.

## The final word: new avenues for global finance in the 21st century?

In this conclusion to the conclusion, first of all the implications of the analysis for future research are examined. Furthermore, I would like to draw attention to the implications of this research for both policymakers and the broader citizenry. The findings of this study and the recent developments in the global financial system point to some important avenues for further exploration by IPE scholars, building on the analysis this thesis provides. Two avenues might prove particularly fruitful: the rise of the emerging markets in global financial governance and the emergence of private governance mechanisms.

The rise of emerging markets (especially the BRICs<sup>76</sup>) is, for example, reflected in the emergence of the G20 as the prime policymaking institution in global financial governance, as well as the increasing voting shares of a number of important emerging markets in the IMF. Where the emerging markets were earlier mainly the subject of policy discussions (e.g. in case of sovereign debt restructurings), the financial crisis has strengthened their role in the global policymaking process and on the global financial markets (for example reflected in the rumours about a Chinese loan to Greece). The possible consequences of this development for our understanding of global financial governance are as yet not fully understood. Shifts in global financial governance have been widely analysed in the IPE literature on multilevel governance (to which this thesis also contributes). This strand of literature focuses mostly on shifts in governance in the sense that certain policy issues are shifted upwards to the global level (e.g. the global coordination of banking supervision in the BCBS). On the other hand, the rise of the BRICs has led to a strand of literature in International Relations that focuses mostly on these states as actors in an inter-state context (examining, for example, consequences for the balance of power). A fruitful area of future research by IPE scholars could seek to fill the gap between these strands of literature through synthesising the valuable insights from both approaches. This would contribute to our understanding of what the rise of the BRICs means for global financial governance, but also what it means for the states in question and their international relations.

A second avenue for further research is offered by the emergence of private forms of governance and the role played by global private interest associations in policymaking processes. Although this thesis has pointed to the importance of the interaction between public and private actors, clearly important private forms of governance are emerging as well (the Principles for Stable Capital Flows are a case in point). Moreover, this thesis has argued that global level private interest associations play an important role in the policymaking process. Up to now, relatively little attention has been paid in the literature to these kinds of private governance arrangements.<sup>77</sup> Relatively little is known about the dynamics of policymaking

<sup>76</sup> Brazil, Russia, India and China.

<sup>77</sup> But see Cutler et al., 1999; Higgot, Underhill & Bieler, 2000; and Fransen, forthcoming 2011.

processes consisting of mainly private sector actors, such as the negotiations leading to the Principles. Furthermore, the aggregation of private sector interests through global business associations like the IIF is often treated as a black box. I would contend that this creates the risk of seeing the private sector as a monolithic bloc, while an important part of the politics of global financial governance is actually contained in the dynamics of private sector negotiations between different types of private firms. Opening this black box of private sector policymaking processes thus offers a fruitful avenue to further our understanding of the developments in global financial governance.

Next to offering fruitful avenues for future research, this thesis also offers a host of practical recommendations for policymakers. From a normative perspective, the legitimacy of this process is central to a well-functioning global financial system.<sup>78</sup> Legitimacy has been famously divided into input legitimacy pertaining to the policymaking process and output legitimacy pertaining to the effectiveness of the governance pattern.<sup>79</sup> Elsewhere, I have argued with Underhill and Mügge that this distinction actually misses the fact that input and output legitimacy are linked.<sup>80</sup> As these are two sides of the same coin, we can improve the functioning of the financial system (output legitimacy) by improving the policymaking process. The prime take-away message for policymakers of this thesis should therefore be that the input legitimacy of financial policymaking must be improved. A wider range of stakeholders should be included, and it should be ensured that these stakeholders engage in substantive discussions on the trade-offs inherent in the global financial system. For example, one practical proposal to achieve this would be 'compulsory' consultations with a wider set of stakeholders.<sup>81</sup> This would mean that the BCBS would not only put a consultative paper on its website and wait for responses, but should actively contact CSOs (including, for example, labour unions) to solicit their responses. The process should not be allowed to continue without wide-ranging inputs and a public discussion on what the BCBS intends to do with these inputs.

Last, but certainly not least, this study offers valuable lessons for concerned citizens. As was pointed out in the introduction to this concluding chapter, the costs and benefits of global financial integration have been distributed unevenly. We should hope improved input legitimacy would lead to better outcomes for a wider public. Different polities may make different choices regarding the trade-offs in the global financial system, and these should be accepted and facilitated by the global policymaking institutions. As the metaphor coined by Underhill goes, countries should be able to 'check out of Hotel Capital Mobility'.<sup>82</sup>

<sup>78</sup> See, for example, Porter, 2001; Germain, 2001 and 2004; Underhill, Blom & Mügge, 2010. A legitimate process could also lead to an accepted definition of what 'well-functioning' would entail.

<sup>79</sup> Scharpf, 1999.

<sup>80</sup> Underhill, Blom & Mügge, 2010. This argument was introduced first in Underhill & Zhang, 2008. See also Jones, 2009b, for an interesting argument about the consequences of relying on output legitimacy in the European Economic and Monetary Union in the context of the current crisis.

<sup>81</sup> For more policy recommendations, see Blom, 2010 and 2011.

<sup>82</sup> Underhill, 2007.

But this should not mean developing global financial governance for the twenty-first century is only up to the decision-making elites. Individual citizens should have the opportunity to exit the global casino that has been built.<sup>83</sup> Offering a wider and more transparent choice in the often opaque financial instruments citizens are consuming would empower citizens to make their own choice for the kind of financial system they want. Do I chose a pension fund that invests in ‘alternative investments’ or do I chose a pension fund that excels at investing in sustainable energy? Does my bank try to offer a slightly higher interest rate through ‘sophisticated’ financial engineering, or does it try to invest in local communities?

By this two-pronged approach of an improved (global) policymaking process and improved opportunities for satisfying market demand of socially responsible financial products, policy space might be created to seek alternatives to the current global financial system and the unbridled expansion of market forces. Most of all, it brings us back to the prime message of this thesis that has relevance for scholars, policymakers and citizens alike: we should not think of politics or market behaviour when thinking of the shape of the global financial system in the twenty-first century, we should rather think of how an integrated understanding of politics and markets can be harnessed to develop courses of action (on markets and in politics) that promote a global financial system that serves our common future.

<sup>83</sup> Strange, 1986. This argument is further developed in Blom, 2011.

## Annex: data sources

### Interviews<sup>1</sup>

For this study 93 interviews have been conducted. Some of these interviews were in the context of the ESRC’s World Economy and Finance Programme focussing on broader questions of the national and international determinants of financial developments. All interviews were structured along the same lines, with specific questions depending on the country and organization involved. Questions pertained to: (1) structure and role of the organization; (2) main issues in financial governance; (3) policymaking process in bank capital adequacy or sovereign debt restructuring case. I furthermore had access to two sets of interviews conducted in the early and late 1990s by Geoffrey Underhill.<sup>2</sup> In the table below, only the interviews which were directly relevant to the case studies in this thesis are listed. Many interviewees provided me with document sources. When relevant, these are listed below under official documents. Documents which were provided in confidentiality are not listed (these are referred to as confidential document sources in the text).

Date	Name	Affiliation	function
27/03/1992	Welsh	Bankers Association for Foreign Trade	general counsel
02/04/1992	Hawley Haraf	Citi Bank Citi Corp	Government Relations office
03/04/1992	Mulloy	US Congress	advisor senate committee
02/10/1992			
03/04/1992	Haseltine Matthews	IIF	deputy MD
24/09/1992	Promisel Ryback	Fed Board of Gov	associate director international finance deputy associate director international banking regulation and supervision
24/09/1992	Mialovich	FDIC	associate director policy and administration
29/09/1992	Hartzell	OCC	deputy controller for international banking and finance

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<sup>2</sup> I am grateful to prof. Underhill for having had the opportunity to build on those interviews.