Renate Mayntz (ed.)

Crisis and Control

Institutional Change in Financial Market Regulation

Max Planck Institute for the Study of Societies

campus

Contents

1 Institutional Change in the Regulation of Financial Markets: Questions and Answers
Renate Mayntz 7

2 The Two-Tiered Politics of Financial Reform in the United States
John T. Woolley and J. Nicholas Ziegler 29

3 Post-Crisis Financial Regulation in Britain
Sukhdev Johal, Michael Moran and Karel Williams 67

4 International Radicalism, Domestic Conformism: France's Ambiguous Stance on Financial Reforms
Nicolas Jabko 97

5 Institutional Change in German Financial Regulation
Stefan Handke and Hubert Zimmermann 119

6 Increasing Vulnerability: Financial Market Regulation in Switzerland
Simon Steinlin and Christine Trampusch 143

7 The Regulatory Response of the European Union to the Global Financial Crisis
Lucia Quaglia 171

8 The Defense of Economic Interests in the European Union: The Case of Hedge Fund Regulation
Cornelia Woll 197

9 What's the Problem? Competing Diagnoses and Shifting Coalitions in the Reform of International Accounting Standards
Paul Lagneau-Ymonet and Sigrid Quack 213

10 New Capital Rules? Reforming Basel Banking Standards after the Financial Crisis
Roman Goldbach and Dieter Kerwer 247

11 Institutional Change at the Top: From the Financial Stability Forum to the Financial Stability Board
Shawn Donnelly 263

12 The International Financial Architecture: *Plus ça change …?*
Geoffrey R. D. Underhill and Jasper Blom 279

Contributors 295

Abbreviations 297

1
Institutional Change in the Regulation of Financial Markets: Questions and Answers

Renate Mayntz

The formation of a research network

The near-collapse of the international financial system in 2008, with its dire consequences for the real economy and state budgets, has generally been perceived as a major global crisis. Crises command the attention of politicians, experts, and the general public and are expected to trigger responsive action. The financial crisis focused political attention first on measures to contain it—in other words, on crisis management—while economists and social scientists started to analyze its causes. Soon there was wide agreement that one prominent cause had been the failure to regulate the internationally expanded financial markets in such a way that their crisis potential—the "market failure" to which they were prone – would be contained. The existing formal rules had significant gaps and created incentives for circumvention and deviation. Banks had not been required to retain on their books part of certain securities they issued; hedge funds and private equity firms were not required to comply with the capital standards of Basel II; and the over-the-counter (OTC) trade of derivatives did not have to be registered, to name just a few of the regulatory gaps that permitted the financial markets to become bloated with "toxic" assets. In unregulated spaces, new practices developed which contributed to the crisis. This holds for the construction of "innovative" financial instruments, such as structured asset backed securities and credit default swaps. At times the effort to avoid compliance with existing rules led to the invention of innovative forms of circumvention; a prominent example is the creation of special purpose vehicles by banks. The new practices that had developed within the given regulatory framework helped to spread the financial crisis to other sectors and other countries when the bubble based on US subprime mortgages burst. "Market discipline" and efforts at self-regulation had obviously been insufficient to prevent the financial crisis; changing the regulation of financial markets therefore appeared the appropriate response.

The observation and analysis of regulatory responses to the crisis was an obvious challenge to sociologists, political scientists, and political economists interested in institutional change. Relevant research started in many places, but

clearly no single research institution was able to set up immediately an empirical project covering all aspects of institutional change triggered by the crisis. This also held for the Max Planck Institute for the Study of Societies (Max-Planck-Institut für Gesellschaftsforschung or MPIfG), whose research program focuses on markets and on institutional change. The MPIfG therefore decided to provide instead a platform for the formation of a collaborative network of researchers dealing with specific aspects of the process of institutional change triggered by the financial crisis.

The study of institutional change requires specification of its empirical referent. The term "institution" is applied to specific normative regimes, to normatively structured social sub-systems, and even to single organizations such as constitutional courts. Financial markets can also be regarded as institutions. They are based on general norms such as property rights, and are peopled by market actors shaped by and subject to legal norms and collectively agreed standards. However, for the network project we decided not to focus on possible future change in financial markets, but on change in the institutions designed to regulate them. Research into institutional change in respect of financial market regulation addresses the structure and practice of supervision, as well as the formulation of new rules, the amendment of existing laws, and the modification of existing standards taking place at different political levels, from the national to the European and the international.

The first steps of network formation were taken in the fall of 2009. In December 2009, Renate Mayntz invited a number of social scientists known to be engaged in relevant work to join the project. In the same month, Till Kaesbach joined the MPIfG to assist with network coordination, and to collect material to keep abreast of the unfolding reform process. The purpose of the network was to gain insight into features of the many-faceted change process that cannot be obtained in a project covering only one component of the financial and regulatory system: features such as the phase structure of the overall process, the relative dominance of activities at different political levels, or the role played by different types of agents, both supporters and opponents of regulatory change. It is this emphasis on the dynamic and characteristics of the macro-process of institutional change then under way that distinguished the MPIfG enterprise from the multitude of studies devoted to a particular agency, financial instrument, or country. In February 2010, seventeen scholars met for a workshop to discuss the aim, design, and guiding questions of the network enterprise, and to suggest additions to the group. Future network members were to contribute, based on their ongoing research, an account of regulatory reform taking place either in a specific country, at the European level, or with respect to an international agency, regulatory standard or financial instrument. Institutional change

was to be studied not simply as an outcome, but as a process unfolding over time (see Hall 2006).

When network formation started in 2009, the financial crisis had already led to a wide-ranging reform discourse. It did not seem unreasonable at the time to assume that by 2011 the process of institutional change would have reached a stage warranting assessment and analysis. At the workshop in February 2010 network members therefore planned to reassemble in a year to present the results of their studies. By the summer of 2010, the network counted 22 members from six different countries. As planned, the concluding workshops of the network took place at the MPIfG in February and March 2011, respectively.

This volume contains a selection of the workshop contributions, nearly all of them in a substantially revised form; revision lasted until September 2011. Not all network members are found among the authors of this book. The aim has been to produce a volume of manageable length, concentrating on events at the three political levels involved in the change process—the national, the European, and the international—and paying more attention to changes in agencies and in rules applied to market actors than in financial instruments. Special emphasis has been put on studies dealing with regulatory change in given countries, for one thing because it turned out that the national level—and in particular the United States and the big European countries—has played and continues to play a dominant role in the regulatory reforms under way globally. This neglects, but does not intend to disavow the importance of the emerging economies to the development of the global financial system—a topic treated in other publications (for example, Underhill/Blom/Mügge 2010). An attempt has been made to have the country chapters answer a common set of questions, but as the network project had not been set up as a comparative study of national responses to be analyzed, for instance, within the framework of the varieties of capitalism approach (VoC), there are considerable differences in the approach, style and implicit normative flavor of these chapters.

The process of change in financial market governance triggered by the financial crisis of 2007/2008 had not fully run its course when, towards the end of 2011, this book went into print. Meanwhile, a second shock wave—the sovereign debt crisis—has overlaid the shock wave of the financial crisis, and the attention of politicians and social scientists alike has shifted to the new crisis. This gives some post-hoc justification to the initial decision to follow institutional change in financial market regulation only until 2011, when it could still be connected to the financial crisis of 2007/2008. As analysts of institutional change are well aware, change processes have no objective beginning or end, but are entities defined by those who decide to investigate a given stretch of sociopolitical development; whatever happens during that period will take on a new

meaning if looked at from some later point in time. The open-endedness of the process analyzed in this book inevitably makes its assessment provisional.

Questions

The questions the network project set out to answer refer to the macro-process of institutional change, but to answer them the individual contributions had to supply factual accounts and focused explanations of what happened in a given country, a given agency, or with respect to a given financial standard. Having graciously accepted this discipline, all authors set out to collect data specifically for this publication. As a result, the chapters in this volume provide valuable case analyses; taken together they give at least tentative answers to the more general questions that were formulated at the beginning of the collective enterprise.

The guiding empirical questions were directed at the process of change, its outcome, and the factors at work in generating that outcome. Macro-processes of planned institutional change move through several phases. Gaps can develop between initial reform intentions and subsequent action, and reform targets can change. Since national, European, and international decision-makers were involved, the question of the relative dominance of a given political level in the reform process was raised. As for the outcome of the change process, we were interested in changes of regulatory structure, and changes in rules. Would there be a pronounced shift away from self-regulation, would agencies disappear or be newly created at the different political levels? Would existing rules become stricter, would there be new rules (legal norms, standards) to guide the behavior of financial market actors and market transactions? With respect to change factors, both the role of potential change agents (drivers as well as opponents) and the role of perceptions and ideas were to be looked at. Since these empirical questions referred to features of governance rather than markets, answers to them were to be interpreted mainly within the framework of theories of institutional change, and of governance. However, all authors were free to develop their own theoretical perspective.

When the results of research undertaken in 2010 were presented and discussed at the workshops in 2011, attention had shifted from the question of *what* was changing, to the question of why so *little* change had taken place. This became a paramount topic in most of the chapters in this book. The results of the collective enterprise thus contribute, more than initially expected, to a theory interested not generally in the trajectory of change processes, but specifically in the conditions making for either radical or incremental institutional change.