Renate Mayntz (ed.)

Negotiated Reform

The Multilevel Governance of Financial Regulation

Max Planck Institute for the Study of Societies

campus

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MAX-PLANCK-INSTITUT FÜR GESELLSCHAFTSFORSCHUNG
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Contents

1 Introduction: Regulatory Reform in a Multilevel Action System

Renate Mayntz

The reform process

The near-collapse of financial markets in 2008, generally perceived as a global crisis, has widely been attributed to the failure to properly regulate a financial system that had undergone international expansion and become increasingly autonomous. Surprised and shocked by the crisis and its threatening economic impact, politicians focused first on crisis management, but soon there appeared to be agreement that comprehensive regulatory reform was needed. Reform initiatives were launched at all political levels, national, European, and international. Given the nearly global expanse of the financial system, it was obvious that these various initiatives should be coordinated.

At the time of the crisis, there existed no coherent governance structure that would have made possible a coordinated, international response to the regulatory challenge. Regulatory competences were concentrated at the national level. The EU had largely refrained from using its legislative powers for the purpose of market shaping rather than for market making, its dominant goal. At the international level, there existed a number of separate bodies of different types (see Baker 2009), but no treaty-based organization to regulate international finance. This is in stark contrast, for instance, to the international trade regime, where the World Trade Organization (WTO) is a recognized international authority. The International Monetary Fund (IMF) is a classic international organization, but its mandate is to assist countries in danger of default, rather than to regulate financial markets. International financial regulation was instead based on "soft" law standards designed by transnational networks of national regulators (Verdier 2013: 1405–1406). These international standardization bodies – the Basel Committee on Banking Supervision (BCBS), the International Organization of Securities Commissions (IOSCO), the International Association of Insurance

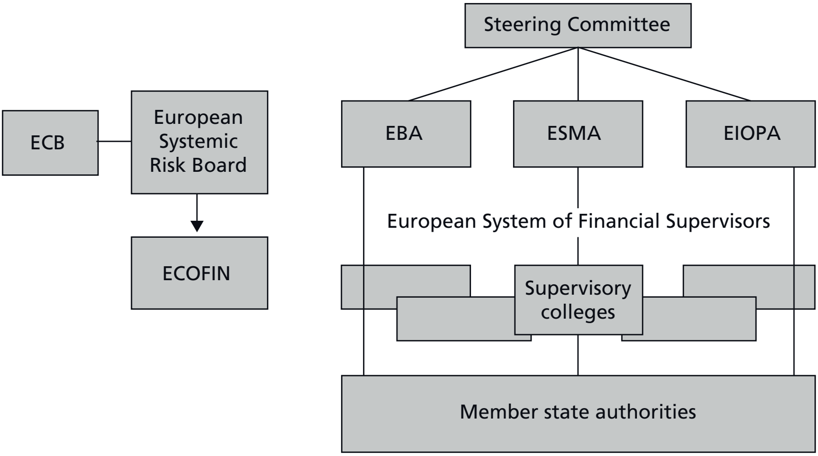
Supervisors (IAIS), and the International Accounting Standards Board (IASB) – depend on voluntary compliance with the rules they develop. In addition, there were international deliberative bodies such as G7, G10 and G20, where mainly the finance ministers and central bank governors of a limited number of countries meet to discuss emerging financial market problems. Finally, there were two platforms with loosely defined functions of coordination: the Joint Forum for the coordination of work by the standard setters and the Financial Stability Forum (FSF) that was to promote collaboration and information exchange among the different bodies dealing with financial regulation and stability. This fragmented international governance structure was the result of developments that took place after the end of the Cold War; they are more closely analyzed in Chapter 2 of this volume.

Given the extreme time pressure, a general overhaul of the regulatory structure prior to starting regulatory reforms was out of the question, so the task was shouldered by already existing authorities and standard-setting institutions. But it was evident that some form of coordination, both internationally and across political levels, was necessary if the crisis was to be overcome and a repeat of it prevented. The reform process that started at the same time at the different political levels had a substantive and an organizational aspect. At the national level, there was a flurry of disparate regulatory interventions in immediate response to the crisis, and there were also changes in the regulatory structure, although their nature and extent varied considerably between countries. In Germany, for instance, a shift of competences from the Federal Financial Supervisory Authority (BaFin) to the German central bank was discussed, but not enacted in the end. In contrast, substantial organizational reforms were initiated and finally realized in the United States and the United Kingdom, the two Anglo-Saxon countries in which deregulation of financial markets has been most pronounced. In both countries, competences were shifted and new agencies were created.[1] Organizational change also took place at the level of the EU, where a new agency, the European Systemic Risk Board, was created, while the three previously existing committees that were supposed to coordinate national supervisors were transformed into European supervisory agencies. These agencies have some decision-making power and the competence to intervene under certain conditions in areas so far under exclusive national jurisdiction (Figure 1-1).

Institutional change at the international level was least evident. No new agencies were established, nor were existing bodies given the competence to make binding decisions for lower level jurisdictions and market actors. There were,

1 For details, see the chapters by Handke and Zimmermann, Wooley and Ziegler, and Johal, Moran and Williams, in Mayntz (2012).

Figure 1-1 European governance of financial markets



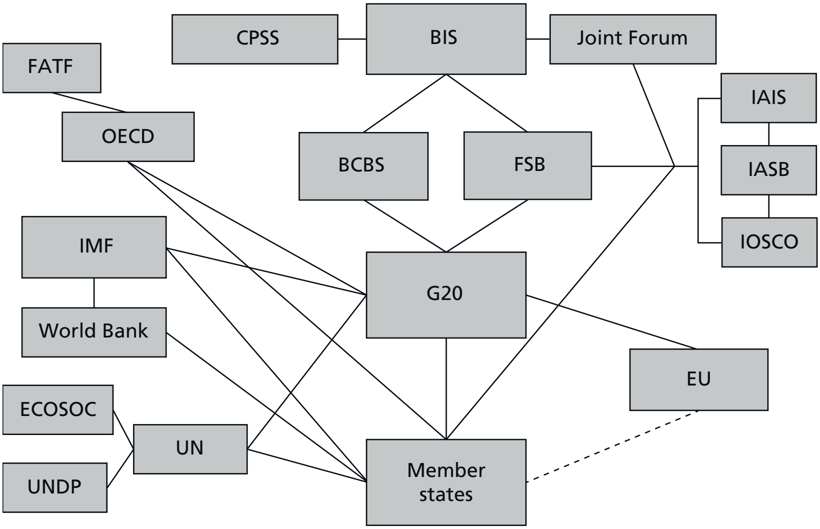
Source: Max Planck Institute for the Study of Societies.

however, changes in the mandate, composition, and weight of some agencies in the overall process of regulation. The G20 had been established in 1999 as a low-key body of central bank governors and finance ministers (who rarely attended in person) to discuss financial matters. In 2008, the G20 heads of government themselves started to meet at highly publicized summits, thus transforming the G20 into the "premier forum of our international economic cooperation" (G20 2009b). The Financial Stability Forum that had mainly served as information broker also changed substantially. Transformed into the Financial Stability Board (FSB), it has since worked closely with the G20. The IMF was given additional resources. Among the standard setters, the BCBS quickly assumed a focal role in the reform process because stricter capital requirements had quickly become a central reform demand. Figure 1-2 shows the international governance architecture as it had developed by 2010, and as it still looks today.[2]

By the middle of 2011 there had thus been a – limited – upward shift of de facto regulatory power, and an (even more limited) upward shift of formal competences in the multilevel governance of financial markets. Because legislative competence is still concentrated at the national level, this upward shift has meant that the downward connection between levels has also become more

2 All figures in this text were prepared by Natalie Mohr.

Figure 1-2 International governance of financial markets



Source: Max Planck Institute for the Study of Societies.

important. The G20 summits have strongly voiced the need for specific reforms and have "tasked" international organizations, as well as national and regional jurisdictions, to become active. The standards formulated by international bodies, notably the BCBS, have served as a template for EU decisions and have also shaped regulatory decisions taken by non-EU countries. EU member states, expecting a new or amended EU directive, often put off introducing new rules by themselves. National decisions were affected by higher level demands and rulings, but national actors were active in formulating these very demands and rulings. By virtue of these upward and downward connections, the policy-making process had become, if not more centralized, more international, and activities at different political levels became more closely linked.

Reform demands voiced after the outbreak of the crisis were radical and comprehensive. At the second G20 summit meeting in London in 2009 the assembled heads of government proclaimed: "We have agreed that all systemically important institutions, markets, and instruments should be subject to an appropriate degree of regulation and oversight" (G20 2009a). Similarly comprehensive reform demands were voiced by the Stiglitz Commission of the UN (United Nations 2009) and the OECD (2009). Banking regulation was to become stricter, rules were to be extended to cover previously unregulated components of the financial system, and regulatory standards were to be harmonized or at least coordinated at the international level in order to make regulatory arbitrage unattractive. Financial market reform quickly became the object of research, by political scientists and political economists alike. The crisis had been a "big bang", and radical regulatory change appeared to loom. At the Max Planck Institute for the Study of Societies (MPIfG) an international group of researchers was formed in 2010 to study the reform initiatives undertaken at the international and the European level, and by selected individual states. This collective research enterprise was concluded in the summer of 2011; the results were published in Mayntz (2012).

By this time it had become obvious that, contrary to early demands for radical reform, regulatory change would be neither comprehensive nor internationally coordinated. As had to be expected, reform plans met with the resistance of the powerful financial industry, but politicians themselves were careful not to strangle a financial system whose functioning was considered essential for the economy. The reforms adopted by the summer of 2011 were admittedly insufficient to discipline risk taking by financial institutions, to deal with the problem of moral hazard presented by banks deemed to be "too big to fail", and to counter the threat of domino effects resulting from the high degree of interconnectedness among market actors. At this stage in the reform process the international financial market crisis was superseded by the European sovereign debt crisis and the related euro crisis. When the attention of political leaders and international organizations turned towards the new issues of sovereign debt, currency problems and economic recession, this had to affect financial reform and in particular banking reform efforts in one way or another. The financial crisis had been a banking crisis; the sovereign debt crisis again involved banks, but now the banks were not the culprits. Banks had been chided for issuing high-risk "subprime" mortgages on a large scale, and for investing heavily in risky securitized mortgages; now they were urged to continue giving credit to the productive economy and to buy government bonds of highly indebted states. The relationship between politics and the finance industry appeared to be reversed: political authorities bent on disciplining financial institutions suddenly found themselves in the position of petitioner. This shift in the balance of power between prospective regulators and the objects of regulation could conceivably have brought the regulatory reform process to a standstill in the fall of 2011. In fact, however, regulatory reform did not come to a standstill. What initially may have appeared to impede a concerted regulatory response – namely the fact that the reform task devolved upon the incoherent set of already existing institutions involved in some way or other in financial market regulation – now worked in favor of a continuing reform process: Once activated by the financial crisis, these institutions simply continued in their job.

Overall, the reform process triggered by the financial crisis has a clear time-profile, moving from the earlier emphasis on bankers' excessive risk-taking and insufficient bank capital to more complex issues, such as the moral hazard posed by increasingly global financial institutions that were deemed "too big to fail" and the threats posed by the unregulated "over-the-counter" trading of complex derivatives. Although the financial crisis had put financial regulation on the political agenda, politicians lacked knowledge of the structure and dynamics of the financial system. Unsurprisingly in this situation, and despite the fact that the crisis was quickly seen as a macro-prudential, systemic problem, the reform approach was micro-prudential at first, targeting individual banks, and the financial incentives that encouraged bankers to engage in increasingly risky trades. Higher capital requirements were another easily understandable measure against risk-taking by banks. Because bank runs threatened, increased deposit insurance was called for and enacted, and consumers – typical small investors – were supposed to receive better information about the risks attendant on specific investments. Measures addressing over-the-counter (OTC) derivatives markets and systemically important financial institutions (SIFIs) started later.

The reform process has also remained selective, if judged against a complete model of the factors contributing to the financial crisis. The agenda for financial market reform was set at the very beginning and has not been significantly revised, let alone extended when attention shifted to different problems. The initial reform discourse has defined the issues to be dealt with by the FSB and international standard-setting organizations, by the European Union, and by individual governments. Potential reform topics that were not on this agenda have not been taken up. One might mention in this regard issues of taxation, the liability of bankers for the consequences of bank activities, and complex forms of securitization, so-called innovative financial instruments (including asset-backed securities [ABS], collateralized debt obligations [CDO], CDO-squared, and credit default swaps [CDS]). The only tax measure discussed – off and on – at various levels, although without a chance of finding international approval, is the so-called "financial transaction tax". Bankers have been held to account for knowingly selling "toxic" securities to unsuspecting customers, but not for the damage caused by risky policy decisions. In addition to the resistance of the financial industry, the complexities of legislation may have inhibited reforms in taxation and liability. The regulation of innovative financial instruments was confronted with the fact that the use of "innovative" forms of securitization was considered to be useful for investors, and not only profitable for banks. The specific selectivity of financial market reform will evidently limit any salutary effects.

The questions

Financial market reform is an ongoing process; it started in another century and will continue, if something similar to our current type of society survives, into the next. The earlier MPIfG project on the reforms triggered by the financial crisis broke off before the process had run its course. By now, however, the reform process has achieved something like an intermediate outcome. In the Communiqué of the Brisbane G20 summit in November 2014, the heads of governments proudly proclaim: "We have delivered key aspects of the core commitments we made in response to the financial crisis. […] The task now is to finalise remaining elements of our policy framework and fully implement agreed financial regulatory reforms" (G20 2014: 2). It is therefore feasible to treat the reform decisions that took place between 2009 and November 2014 as a "case" to be analyzed.

The reform process that constitutes this case can be analyzed from various theoretical perspectives: by evaluating its outcome and explaining possible shortcomings; by asking about its effects on the international financial system; by focusing on the problem of the democratic legitimacy of a policy process dominated by experts and executives; by comparing reforms in the "varieties-of-capitalism" perspective; or by investigating the interactions between the national, regional, and international institutions involved in the process. At a workshop in December 2013, scholars who had contributed to the volume resulting from the earlier project on financial market reform (Mayntz 2012) met at the MPIfG to discuss the continuation of the reform process. At this workshop, the participants decided to produce a joint volume focusing on the multilevel interactions in the process of regulatory reform. The multilevel perspective on the process of regulatory reform was chosen for a variety of reasons. The effects that reforms will ultimately have on the structure and functioning of the financial system will become visible only when agreed reforms have been implemented, and it will be extremely difficult to attribute observable changes causally to specific reform measures rather than to geopolitical developments and changes in the global economy. To adopt the VoC perspective, as Peter Hall has done in analyzing the euro crisis (Hall 2014), would have required a substantially broader selection of countries than the three figuring in this book. The issue of shortcomings in terms of democratic input legitimacy has frequently been raised in the post-crisis literature on financial market governance, but there is a dearth of studies focusing on the multilevel character of the regulatory reform process. Joined by some new authors, the group presented and discussed the draft chapters of the planned book at the MPIfG in December 2014.

The dominant concern in this book is the way in which the given multilevel structure of financial regulation shapes the process of regulatory reform. Obviously, the vertical and horizontal interactions in this multilevel governance structure affect the outcome of the reform process. But our interest is less in a summary assessment of reform results than in the extent and forms of coordination in a policy process that stretches over several political levels, from the national to the international. Ours, however, is not a typical case of multilevel governance. In typical cases of multilevel governance – that is, in federal systems or the European Union – higher *and* lower level entities have decision-making competences, and interact in a process of joint decision-making (Scharpf 2010: 201–207). This theoretical model does not entirely fit the case of financial regulatory reform, where crucial top-level bodies do not have formal decision-making competences. Thus we set out to study empirically the interactions between the national, regional, and international levels in the process of financial market reform from the perspective of actors at given levels. Have regulatory initiatives conceived at the international level been taken up and translated into binding rules at lower levels? Have the United States, the former regulatory pace-setter, complied with regulatory changes asked for at the international level, or have they tried to imprint US preferences on these templates? How have member state preferences shaped European Union decisions? Has the European Union translated the G20 reform agenda into directives and framework laws, or has the EU developed its own initiatives? Have countries copied reforms from each other or have they formed coalitions to push for or to defeat a given reform? From the chapters in this book, we hope to derive answers to these questions.

In the conceptual framework guiding the joint work on this book, we focused on vertical and horizontal interactions in the policy process spanning multiple levels. Initially we used three core concepts for the interactions we focused on: "downloading", meaning adoption of a higher-level rule by a lower-level jurisdiction; "uploading", meaning shaping a higher-level rule according to lower-level preferences; and "crossloading", meaning horizontal policy transfer. But this conceptual frame soon proved too simple. "Downloading" need not mean compliant implementation, but may mean only formal adoption, and adoption need not be total but may involve – more or less significant – modification. There are likewise different routes and channels of "uploading" political preferences to a higher level body; different countries can form coalitions to push for or to defeat a given higher-level proposal, or they can act alone. "Crossloading", finally, can mean transfer, simple copying, learning from the solution found by another jurisdiction without copying it, or arriving at a mutually agreed solution. The great variety of horizontal and cross-level interactions in the formation of different parts of regulatory reform will be evident in the different chapters, even where no finer terminological distinctions are made.

The global financial crisis may have had a specific trigger in the US subprime mortgage market, but it had many different causes, both proximate and remote. A reform that aimed to prevent a recurrence of the 2007/2008 crisis therefore had to go to its multiple roots. This called for a bundle of measures, addressing different factors that had contributed to the crisis. It would have been impractical, if not impossible for the small group of scholars attending the December 2014 workshop to trace the multilevel interactions involved in all regulatory reforms triggered by the financial crisis. We therefore decided to focus on a limited set of particularly salient, both early and later reforms. This set consists of (i) the Basel III reforms (bank equity, leverage, liquidity), (ii) the provisions for the resolution of systemically important financial institutions without need for taxpayer bailouts, (iii) over-the-counter trading of derivatives in the shadow banking sector, and (iv) structural reforms to separate commercial banking from the risks involved in investment banking and proprietary trading. As is true of any selection, this one can be challenged. Why have structural reforms been included in our selection, although this issue has hardly been addressed at the international level? Our selection of substantive reform issues thus underlines the fact that in the overall process of regulatory reform, not all issues are dealt with equally on all levels.

In Chapter 2 of the present volume the specific character of the multilevel policy-making system that evolved in response to the crisis is set in the wider perspective of change in the form of global governance. In Chapter 3 the role played and the (non-binding) decisions taken by international bodies with regard to the selected substantive issues are analyzed. Chapters 4 to 7 try to show whether the EU or a given country has tried to influence international agreements on these matters, how they responded to higher-level standards and (binding or non-binding) decisions (rejecting, ignoring, or accepting them, with or without modification), and where they developed independent initiatives. The final chapter attempts to identify the modes of cross-level coordination in the process of reforming financial market regulation shown by these empirical findings, and to reflect this multilevel dynamic in the context of a revised theory of multilevel policy-making.

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2 The Governance Shift: From Multilateral IGOs to Orchestrated Networks

Lora Anne Viola

Introduction

The 2008 global financial crisis not only exposed the need for regulatory reform but also highlighted the decentralized and largely uncoordinated nature of financial governance institutions. Over the past several decades, the global financial regulatory regime has increased in size and sophistication (for an overview of this evolution see Davies/Greene 2008; Helleiner et al. 2010). The regime comprises a large number of diverse actors, including intergovernmental organizations (IGOs), public standard-setting bodies, and private regulatory bodies. In addition to the original Bretton Woods institutions, including the IMF and the World Bank, central actors include the Basel Committee on Banking Regulations and Supervisory Practices, the Financial Stability Forum (now the Financial Stability Board [FSB]), the International Organization of Securities Commissions (IOSCO), and the International Accounting Standards Board (IASB), along with numerous other industry groups, committees, and national bodies. The crisis made clear that the proliferation of fragmented regulatory bodies had introduced inefficiencies, the potential for regulatory arbitrage, as well as unexploited synergies in the regulation of targets.

As a result, many observers have called for institutional reforms aimed at better coordinating regulatory governance efforts. According to Eichengreen (2009: 18), "[e]fforts to share information, apply peer pressure, and correct regulatory problems through the deliberations of the Financial Stability Forum, the Basel Committee on Banking Supervision and colleges of supervisors […] have been shown by the crisis to not be up to the task." Eichengreen is among a few analysts who have called for a new supranational IGO, something like a World Financial Organization (WFO) analogous to the World Trade Organization, to centralize financial sector governance (Eichengreen 2008, 2009; Claessens 2008;

Eatwell/Taylor 2000). "The WFO would define obligations for its members; the latter would be obliged to meet international standards for supervision and regulation of their financial markets and institutions" (Eichengreen 2009: 19). Other proposals focus on increasing the capacity and competences of existing organizations, primarily the IMF. In addition to general calls for strengthening IMF surveillance activities and its ability to quickly provide large amounts of emergency liquidity, Eichengreen has proposed increasing the political independence of the IMF, removing power from the Executive Board and giving more power to managing directors, making them similar to central bank policy committees (Eichengreen 2009).

As it happens, the crisis did not give rise to anything resembling a WFO and neither was the IMF's independence and oversight capacity enhanced in a way that would make it a *de facto* WFO. Rather, state leaders quickly turned to the G20 format, which had hitherto existed only in the form of a finance ministers' forum, and used it as a focal institution where they could meet to discuss and coordinate national responses to the crisis. Thus it was the informal G20 leaders' summits, supported by the G20 finance minister meetings, that took the pivotal role in coordinating a global response to the crisis and the subsequent reform efforts (see Figure 1-2 of Chapter 1, this volume). Indeed, at the 2009 Pittsburgh Summit, member states declared the G20 to be the "premier forum" for economic coordination.

From a governance perspective, the turn to the G20 rather than to a WFO or enhanced IMF is puzzling. The G20 has no formal mechanisms for aggregating preferences (for example, voting procedures), it has no institutional capacity (for example, a secretariat or bureaucracy), it lacks expertise, its decisions are not legally binding, and it lacks universal membership (which may present problems of both effectiveness and legitimacy). In contrast, the IMF has both a formal mandate and decades of experience with promoting monetary cooperation, facilitating balanced growth, and guiding economic restructuring. In addition, it has a large staff of experts, formidable institutional capacity, and close contact with regulatory targets. Why, then, did the G20 summits become the nodal institution during the crisis rather than the IMF or a WFO? And, considering its weaknesses, what kind of governance could the G20 offer?

The turn to the G20 at the beginning of the crisis, I argue, is symptomatic of a broader move away from governance centralization and towards a more pluralistic and fragmented institutional environment (see also Baker 2009). A number of factors, including the increasing importance of transnational and transgovernmental actors, issue complexity, and actor heterogeneity are moving governance away from traditional, formal, universal intergovernmental organizations (IGOs) towards a proliferation of less formalized, more ad hoc and specialized "clubs" of common interest. Far from being coordinated multilaterally within a centralized IGO, financial market regulation – as the contributions to this volume demonstrate – happens on multiple levels, ranging across sub-national, national, regional, and international jurisdictions, and involves a number of institutions composed of public, private, and hybrid actors. This fragmented institutional field is becoming familiar terrain for a number of issue areas, including environmental and health policies, and reflects – following Slaughter – the development of a form of network governance (Slaughter 2004; Slaughter/Hale 2010; see also Alter/Meunier 2009; Woods/Martinez-Diaz 2009).[1]

A crucial question, however, is what kinds of governance modes are available in a fragmented institutional environment? Given diverse specialized, exclusive, and sometimes weakly formalized institutions, traditional modes of governance, including hierarchy and delegation, can be difficult to achieve. A network of institutions, I argue, requires a nodal actor (or actors) in order to be effective at governance and regulation. This nodal actor, in turn, exercises "soft" governance through what Abbott et al. (2015) have termed "orchestration". Indeed, at the international level the G20 has taken on the quality of a nodal actor within the fragmented network of global financial institutions and, despite its weak institutionalization, has exercised governance by enlisting and endorsing the work of other bodies within the regulatory regime. As the global financial crisis recedes and the urgency of coordinating reform and responses slackens, the importance of the G20 as a nodal actor has also begun to wane.

The chapter proceeds in three parts. First, I discuss the governance shift with regard to characteristics of the global financial regulatory regime, including its actors, institutional preferences, and available modes of governance. I argue that issue complexity and increasing actor heterogeneity, including the rise of transnational actors and emerging states, have increased state preferences for less formalized, ad hoc, and more exclusive institutions. Such institutions, however, face difficulties engaging in top-down governance or even delegation. As a result, they will tend to engage in orchestration to coordinate and endorse, rather than centrally control, the fragmented institutional environment. Second, I show how the G20 format fits this development and, consequently, made it more acceptable than the IMF or a potential WFO to serve as a pivotal actor during the crisis. Third, I consider some implications of these arguments for the effectiveness of governance and regulatory reform.

1 Even the WTO, the exemplar of global supranational regulation, may be undermined by the proliferation of bilateral and plurilateral trade negotiations such as TPP and TTIP.

The governance shift

The pluralization of governance actors

During the period of institutional creation following World War Two, states created IGOs to assist in the coordination and management of distinct policy areas. IGOs were designed with a high degree of functional differentiation from one another and were meant to concentrate competences within their individual bureaucracies. Specific policy areas were thus to be addressed within the dedicated IGO, such as health (World Health Organization), security (United Nations Security Council), nuclear energy (International Atomic Energy Agency), the international monetary and financial system (International Monetary Fund), and development (World Bank). Over the past several decades, and especially since the end of the Cold War, however, there has been a dramatic increase in the number and type of institutions involved in any given governance issue. This has been true in the fields of global health, where the World Health Organization no longer has a monopoly on global health policy but shares the policy stage with the Bill and Melinda Gates Foundation, GAVI, many health-related NGOs, and others (Viola 2013; Hanrieder 2015). It is true of the environment, where failure to come to a global solution on climate change has spurred a number of arrangements located at various other governance levels and including a diversity of actors (Biermann/Battberg/van Asselt 2009). And it has certainly been true of financial governance where regulatory policy is developed not only by states in the traditional Bretton Woods institutions, but also within issue-specific committees, public/private standard-setting bodies, and private (industry) regulatory bodies. Overall, the increasing number and importance of these new actors has changed the international institutional environment by weakening the traditional monopoly of field-specific IGOs and by making the institutional environment more pluralistic. This means a more crowded and fragmented governance environment, including more potential for both complementarity and competition.

In the area of financial governance, functional needs resulting from issue complexity and the policy relevance of non-state actors contribute to this change (Büthe/Mattli 2011). As the financial system has become more complex, regulatory policies have relied on increasingly complex modeling and risk management strategies. Issue complexity means that regulation relies on information and expertise that is highly specialized and distributed among a larger number of actors at multiple levels of governance.[2] It has also meant breaking down regulatory

2 Even in those areas in which the issues per se are not changing in complexity, we see the international level becoming more engaged in the governance of complex and technical questions that were once addressed exclusively at the domestic level (Zürn 2008).