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The Distributional Consequences of International Finance: An Analysis of Regulatory Influence

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1. Introduction

The last three decades have witnessed a profound transformation in the regulation and supervision of financial institutions across the globe. As economic integration has deepened and the capacity of national governments to control financial activity within their borders has declined, the locus of regulation has gradually shifted from the domestic to the transnational level. At the same time, the increasingly evident limitations of public forms of financial regulation – in particular, the lack of sufficient technical expertise and material resources to deal with increasingly complex regulatory challenges – have led governments to delegate extensive regulatory authority to policy networks, private-sector organizations, and other nonstate regulatory bodies (Abbott & Snidal 2009; Büthe & Mattli 2011). In short, a distinct “transnational regulatory space” has emerged in the financial sphere – a space that has been fiercely contested by a diverse range of public and private actors (Cafaggi & Pistor 2013).

Given the significance of these developments, it is surprising that scholars in the fields of political science, law, sociology, and economics have not sought to gain a deeper understanding of *how* and *to whose benefit* the transnational regulatory space in finance has been divided. That is, they have paid relatively little attention to questions concerning the distribution of benefits and burdens in global financial regulation, such as: Who are the key public and private stakeholders involved in the development of international financial rules? What are the preferences of these actors and what types of lobbying strategies do they employ to secure their favored rules? What are the most important factors determining success in achieving desired distributional outcomes? Are the distributional effects of transnational rules equitable or are there winners and losers?

In this study, I seek to shed light on these issues by conducting a microfoundational empirical analysis of two transnational regulatory regimes that are central to the efficiency and stability of the global financial system. The first is the Basel Committee on Banking Supervision (BCBS), a group of central bankers and financial supervisors that formulates international capital adequacy standards for banks. I examine the interests, lobbying strategies, and bargaining power of key private stakeholders in two major rounds of BCBS negotiations: the Basel II accord (1999-2004) and the Basel III accord (2009-2011). In particular, I focus on the intense distributional battles waged within the banking sector between large internationally-active banks from developed nations, smaller regional lenders in these countries, and emerging-market financial institutions. The second regime I analyze is the International Accounting Standards Board (IASB), a private-sector organization that sets financial reporting standards for companies around the world. Here, my analysis centers on the conflicts fought between global accountancy firms based in Anglo-Saxon countries – in particular, the so-called “Big Six” and subsequently “Big Four” firms – and businesses, investors, and regulatory authorities in continental Europe and elsewhere.

I develop an analytical framework that accounts for the widely varying levels of regulatory influence enjoyed by these stakeholders. This framework, which I call *technical elite network* (TEN) theory, draws attention to how issue-specific characteristics of global finance – in particular, its highly technical and complex nature – shape the distributional consequences of transnational regulatory processes. It emphasizes two mechanisms by which such characteristics influence distributional outcomes. First, they affect which stakeholders have

access to regulatory officials' informal social networks (ISNs) – networks that play a crucial role in determining who claims first-mover position and thus sets the agenda in global financial rulemaking. Second, they give rise to distinctive increasing returns processes that serve to reinforce and entrench proposals made at an early stage of rulemaking, guaranteeing that first movers exert an enduring influence over the content of international standards. TEN theory offers a powerful yet parsimonious explanation for distributional outcomes in the BCBS and IASB. An in-depth examination of the conflicts waged within these regulatory regimes provides strong support for the theory's predictions and causal mechanisms while at the same time casting doubt on alternative explanations, in particular those drawing on realist and neo-Marxist theory in international relations (IR).

The study is organized as follows. Section 2 reviews existing attempts to explain distributional outcomes in global finance. Section 3 sets out TEN theory in greater detail. Sections 4 and 5 assess the empirical evidence for the framework vis-à-vis alternative theories in the areas of capital adequacy and financial reporting, respectively. Section 6 concludes by reflecting on the implications of the analysis for designing regulatory regimes in global finance that respond to the interests of – and ensure an equitable distribution of regulatory capabilities among – a broad range of stakeholders.

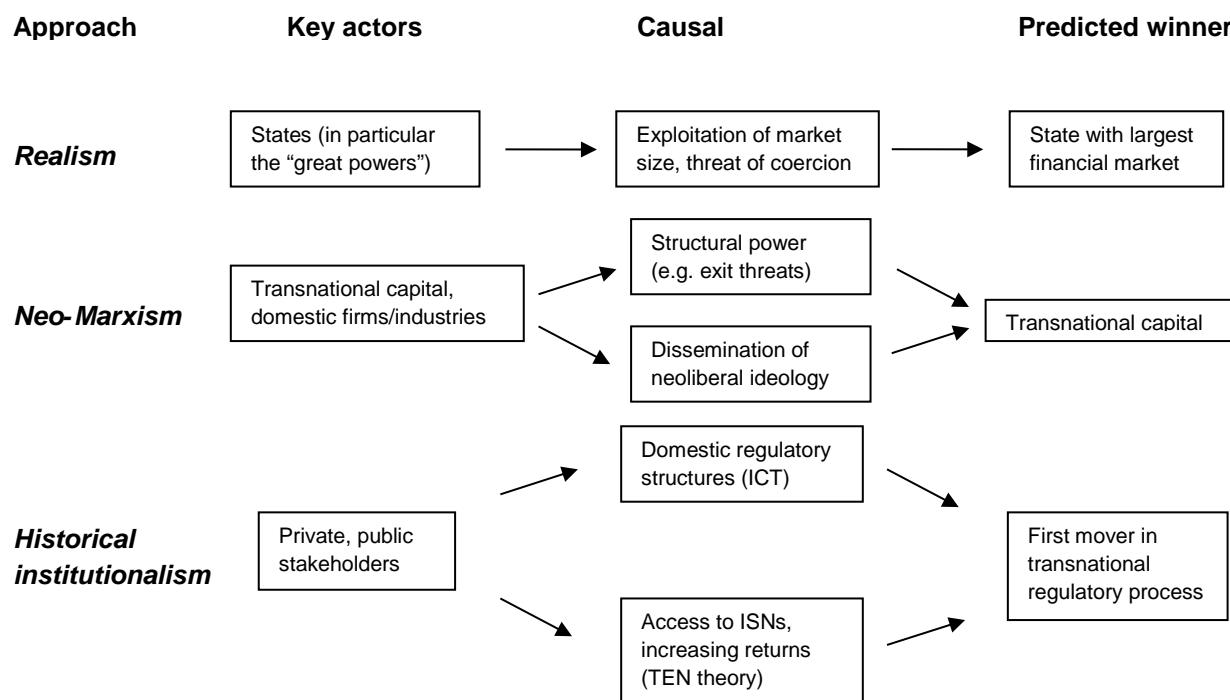
2. Surveying the political science literature

The few existing attempts to explain distributional outcomes in global finance can be grouped into three broad approaches. Perhaps the most influential approach takes inspiration from the realist tradition in IR. Simmons (2001) emphasizes the role of the world's dominant financial center – the United States (US) – in determining whether and how financial regulatory harmonization occurs. The size of its internal financial market, Simmons argues, gives the US both the incentive and means to unilaterally impose its regulatory preferences on other countries. More recently, Drezner (2007) has argued that transnational rules in finance (and elsewhere) principally reflect the preferences of the “great powers” in the global economy, in particular the US and the European Union (EU). Similarly to Simmons, Drezner argues that it is the prospect of access to these actors' sizeable internal markets – together with the threat of economic coercion – that induces weaker states into accepting their domestic regulatory status quo at the transnational level.

A second approach to analyzing distributional outcomes, which challenges the realist assumption that states are the key actors forging global financial rules, comes from the neo-Marxist school of IR. Neo-Marxists draw attention to the distributional conflicts fought among distinct (subnational or transnational) classes of societal actors with shared economic interests. In particular, they focus on conflicts between holders of mobile financial capital, such as large international banks, and domestically-oriented firms and industries. One variant of the neo-Marxist approach posits that capital holders extract regulatory concessions by exploiting their “structural power” – that is, their ability to relocate or scale down investments (Perry & Nölke 2006; Underhill & Zhang 2008). Another variant points to their success in promoting neoliberal ideology – with its self-serving emphasis on privatization, free markets, and deregulation – within the regulatory community (Soederberg 2004).

A third and particularly promising approach draws on the historical institutionalist tradition in comparative politics. This approach conceptualizes financial rulemaking as an incremental process that unfolds over time, and posits that the timing and sequencing of events and actions in this process plays a crucial role in determining winners and losers (Farrell & Newman 2010; Fioretos 2010; Posner 2010; also see Farrell & Newman forthcoming). Although enhancing our understanding of the temporal dimensions of transnational regulatory processes, it has yet to offer a fully-fledged framework for analyzing the distributional effects of global financial rules. A partial exception is Bach and Newman's (2007) analysis of how the sequence in which jurisdictions build "regulatory capacity" – that is, the ability to "formulate, monitor, and enforce a set of market rules" (p.831) – affects their relative influence over international standards. Another exception, which draws more explicitly on historical institutionalist reasoning, is Büthe and Mattli's (2011) institutional complementarity theory (ICT). ICT posits that stakeholders in countries with "fragmented" regulatory systems characterized by competition among multiple standard-setters are less successful in influencing global rules than actors in nations with "hierarchical" systems (in part) because they become involved in international standardization projects at a later stage.

Figure 1. Causal processes and predictions of different theoretical approaches



Naturally, we can only assess the validity of these three approaches on the basis of concrete empirical evidence. Testing the approaches against one another, however, is not a straightforward task. In some cases, they generate almost identical predictions about distributional outcomes. As discussed in Section 4, for instance, both neo-Marxist and historical institutionalist theories may lead us to expect that large international firms will be

the principal beneficiaries of global financial rules. To discriminate between different theories predicting the same outcome, empirical tests must focus on the implied *causal processes* leading to that outcome (George & Bennett 2005, pp.217-20). Other things equal, the theory whose posited causal process exhibits the closest fit with observed developments has the strongest *prima facie* claim to validity. Process-related tests among competing approaches are thus an essential means of establishing robust causal inferences about the factors determining distributional outcomes in global finance. Figure 1 provides a diagrammatic representation of the causal processes implied by the three approaches.

3. Technical elite network theory

Rulemaking in global finance is a multiphase process.¹ International standards are not adopted during a single meeting between regulatory officials; instead, they are developed over a number of distinct stages, typically including an agenda-setting stage, a planning or preparatory stage, a discussion paper stage, a consultation stage, and an approval stage. Collectively, these stages may last years or even decades. Not all stakeholders become involved in this protracted process at the same stage: while some actors influence rules as early as the agenda-setting or planning stage, others are largely absent from regulatory negotiations until the consultation or approval stage.

TEN theory accepts a central insight of the historical institutionalist approach, namely, that stakeholders who become involved in global financial rulemaking at an early stage tend to enjoy greater influence over international standards than stakeholders arriving later. Unlike existing historical institutionalist theories, however, it posits that the key *causes* and *distributional consequences* of timely involvement derive from issue-specific characteristics of international finance. The most important of these characteristics is the domain's high – and ever increasing – level of technical complexity (Porter 2003, forthcoming).

Technical complexity affects the causes of timely involvement by influencing which stakeholders have access to regulators' ISNs – a critical determinant of first-mover advantage in global financial regulation. ISNs can be defined as patterns of repeated, enduring social relations among core formal rule makers and (some small subset of) industry actors involving the exchange of information, expertise, and other material and nonmaterial resources. Unlike the well-known “transnational regulatory networks” described by scholars such as Raustiala (2002) and Slaughter (2004), ISNs include stakeholders as well as employees of regulatory agencies. Yet as the above definition implies, not all stakeholders enjoy access to ISNs: only the select few who maintain close personal relationships with officials and regularly interact with them outside formal regulatory negotiations can be classified as “members.”

The technical nature of global finance influences access to ISNs by creating incentives for officials to interact more frequently with stakeholders who possess a high degree of specialized knowledge. Importantly, the distribution of such expertise is heavily asymmetric: only a handful of stakeholders – namely, individuals with extensive first-hand knowledge of global markets garnered from years of professional experience at the helm of the world's largest financial institutions – possess the technical know-how to contribute to the development of international financial standards. Many of these individuals possess a level

of expertise exceeding even that of officials (Griffith-Jones & Persaud 2008). Consequently, regulatory bodies frequently recruit from the ranks of the largest financial firms and rely on the assistance of their most senior experts to write rules that are operationally viable.

How does access to ISNs enable stakeholders to shape regulatory proposals at an early stage? First, ISNs provide stakeholders with timely and high-quality information about the international regulatory agenda, which enables them to contribute to new standardization initiatives before others even become aware of them. Second, in part due to their expertise, members of ISNs are more likely to be delegated important functions in the early development of rules, including participating in advisory panels assessing the merits of new standards at the agenda-setting stage; providing technical advice and administrative support to rulemaking bodies through secondments, internships, and other temporary staff transfers; and conducting feasibility studies or cost-benefit analyses of prospective standards at the planning or discussion paper stage. As noted earlier, regulators often *depend* on the expertise provided by ISN members to develop rules that make operational sense. Finally, membership provides opportunities for stakeholders to use their first-hand knowledge of global financial markets to draw officials' attention to deficiencies or gaps in existing rules and suggest ways of remedying such problems that reflect their regulatory preferences. In doing so, they are able to set the regulatory agenda by putting forward new proposals rather than merely influencing the content of existing ones.

The incorporation of ISNs into the analysis of first-mover advantage gives TEN theory two advantages over existing historical institutionalist theories. First, it renders the theory more generalizable both *within* and *outside* global finance. Büthe and Mattli's ICT, for instance, only applies under a limited set of conditions, namely, when there is (1) variation in the fragmentation of domestic standard-setting bodies across countries and (2) a single, uncontested (or "focal") regulator at the global level. These conditions are not always satisfied, even within global finance. In areas such as securities regulation, for instance, there is little fragmentation at the domestic level; in areas such as hedge fund regulation, meanwhile, there is no focal global rule maker. In contrast, ISNs can be found in almost all issue areas in which (1) a high level of technical expertise is required to formulate global rules and (2) such expertise is concentrated in a small number of stakeholders. This includes most domains of global finance, in addition to nonfinancial issue areas as diverse as chemicals, pharmaceuticals, information technology, and insurance.

The second advantage of integrating ISNs into the analysis is that it enables us to account for *intra-societal* differences in regulatory influence at the transnational level. Both ICT and Bach and Newman's analysis imply that divisions between first movers and second movers necessarily occur along national lines. Yet as cases such as international banking regulation illustrate, there is often substantial variation in the point at which stakeholders from the same country become involved in the transnational regulatory process (see Section 4). By drawing attention to ISNs – which straddle national borders and include only a small fraction of stakeholders in any given country – TEN theory helps to explain such variation. Indeed, insofar as it accommodates conflict between transnational groups of nonstate actors, the theory has affinities with the neo-Marxist approach. Unlike this approach, however, it rejects the notion that either structural power or the ability to disseminate self-serving economic ideas is a sufficient condition for influencing global rules. Without the temporal advantage provided by membership in ISNs, it suggests, such resources will count for little.

Issue-specific characteristics of international finance shed light not only on the causes but also the distributional consequences of timely involvement. That is, they help us to understand *why* stakeholders who secure first-mover position tend to enjoy greater regulatory influence than latecomers – an issue that has been surprisingly overlooked by existing historical institutionalist theories of global finance. I posit that such characteristics give rise to distinctive increasing returns processes that render proposals made by first movers progressively more difficult to change as they move through the stages of global financial rulemaking (Pierson 2000; Pierson & Skocpol 2002). Specifically, I highlight two processes by which rules proposed at an early stage tend to reinforce and perpetuate themselves, each arising from a different characteristic of international finance.

The first process is rooted in the large set-up (or fixed) costs involved in formulating standards, a consequence of the technical nature of global finance.² Developing an item on the standardization agenda into a preliminary working draft or discussion paper – detailed documents that frequently run into hundreds of pages – requires extensive research, planning, deliberation, and drafting on the part of rule makers. The sheer size of this initial investment in terms of financial resources, organizational capacity, and time renders the cost of abandoning an existing regulatory proposal prohibitively high. Exit may be rendered even more difficult by the fact that, as mentioned earlier, many of the technical experts delegated the task of developing the proposal are themselves private actors who actively lobbied for it be considered in the first place. The combination of high sunk costs and political pressure from “within” ensures that regulatory bodies in global finance tend to strongly oppose discarding provisions at an advanced stage of the standard-setting process.

The second process by which early regulatory proposals become entrenched follows from the nongovernmental character of regulatory organizations in international finance. In intergovernmental regimes, rules may be blocked by states during the latter stages of the regulatory process if they are believed to adversely affect some group of domestic constituents.³ Governments are directly accountable for failing to protect domestic stakeholders, creating strong incentives for them to ensure that international rules are acceptable to a broad range of societal interests (Putnam 1988). Nonstate regulatory bodies, on the other hand, have no formal accountability to the citizens of countries under their jurisdiction. Since officials cannot be sanctioned for failing to defend the interests of particular domestic groups, they have little reason to block provisions on public interest grounds during the final stages of the regulatory process. The upshot is that rules proposed at an early point in negotiations – rules in which regulatory experts subsequently invest substantial resources – have a high likelihood of being eventually adopted.

To summarize, TEN theory offers two distinctive propositions about the determinants of regulatory influence in international finance. First, stakeholders who enjoy access to regulators’ exclusive ISNs – that is, stakeholders who possess high levels of specialized knowledge – are likely to secure first-mover position and hence set the agenda in global financial rulemaking. Second, owing to a dynamic of increasing returns, proposals made at an early stage of rulemaking tend to become entrenched in self-reinforcing ways, preventing second movers from altering them at later stages and hence ensuring that first movers have an abiding influence over international standards.

4. International capital adequacy standards

In this section, I assess the empirical support for TEN theory by examining the case of international capital adequacy standards.⁴ During the past quarter-century, capital adequacy standards have emerged as the principal form of prudential regulation for financial institutions. These rules stipulate the minimum level of regulatory capital – a mixture of shareholders' equity, disclosed and undisclosed reserves, loan-loss provisions, and other financial instruments – that banks are required to maintain as a proportion of their total risk-weighted assets. The rationale for regulatory capital is to provide a “buffer” against unexpected losses incurred by banks. By reducing the risk that such institutions will become insolvent during periods of low or negative earnings, they play a key role in maintaining a stable supply of credit and payment services to the real economy.

At the same time, capital requirements have a significant impact on the distribution of wealth both *among* banks and *between* the financial sector and the real economy (Cafaggi & Pistor 2013). Since capital is a more expensive source of financing than debt – largely due to tax advantages and implicit government guarantees for the latter – banks view capital adequacy standards as a form of “regulatory taxation.” By lowering capital levels, banks can reduce funding costs, increase leverage, and boost their return on equity. Institutions with sizeable asset portfolios can save billions of dollars through a tiny percentage reduction in capital requirements, gaining a major competitive advantage over rivals. In this section, I show how large international banks succeeded in systematically weakening the provisions of Basel II and Basel III to minimize their required levels of capital, with adverse competitive implications for both smaller rivals and financial institutions in the developing world.

Throughout the section, I attempt to evaluate TEN theory against the alternative analytical approaches discussed earlier. Since process-related tests are critical to assessing the validity of these competing approaches (see Section 2), I employ the technique of process-tracing. An in-depth examination of original BCBS documents, press releases, interview transcripts, and other primary and secondary sources provides the ideal method for investigating whether “the observed processes among variables in a case match those predicted or implied by [a] theory” (George & Bennett 2005, p.217).

4.1. Basel II (1999-2004)

Basel II was the successor accord to Basel I, the first international framework for capital regulation, which was agreed in 1988. Basel I set minimum capital standards based on two ratios: a ratio of Core Tier 1 capital to risk-weighted assets of 2 percent; and a ratio of Tier 1 plus Tier 2 capital to risk-weighted assets of 8 percent (BCBS 1988).⁵ Assets were risk-weighted according to the credit risk of the borrower – that is, the risk of the borrower defaulting – which was predetermined by the BCBS.

In September 1998, partly in response to the Asian financial crisis, the BCBS decided to replace Basel I with a more stringent set of rules: Basel II. The most important innovation in Basel II was the inclusion of an “advanced internal ratings-based” (A-IRB) approach under which large banks would be able to use their own models to estimate various aspects of credit risk. Banks lacking the resources to develop internal models would adopt the

“standardized” approach, which linked credit risk to external ratings issued by credit rating agencies. Crucially, internal ratings would give large banks a major competitive advantage over smaller rivals. One impact study conducted by the BCBS, for example, showed that A-IRB banks would experience a capital reduction of up to 26.7 percent, while banks adopting the standardized approach would see a 1.7 percent *increase* (BCBS 2006, p.2). A 2006 survey by Ernst & Young, meanwhile, found that 75 percent of banks believed that Basel II would benefit the largest banks employing advanced risk modeling systems at the expense of institutions unable to adopt them (Thal Larsen 2006).

What explains Basel II’s remarkably inequitable distributional effects? The realist approach fails to provide a satisfactory explanation (Wood 2005). Contrary to its expectations, Basel II did not reflect the preferences of any specific country represented on the BCBS; rather, it promoted the interests of large international banks *irrespective* of their national origin. Indeed, even in the US – viewed by realists as the dominant member of the BCBS – legislators complained that Basel II undermined national interests by jeopardizing the viability of small banks (Chaffin & Pretzlik 2003). The neo-Marxist approach correctly predicts the accord’s winners and losers. Yet evidence for neo-Marxism’s posited causal mechanisms – the strategic deployment of structural power and neoliberal ideology – is sparse. By the early 2000s, Basel I had been implemented in more than 100 countries – almost all of which intended to adopt Basel II – rendering threats to relocate to unregulated jurisdictions non-credible. As discussed later, large banks sought to promote their preferred rules not through the use of exit threats but by appealing to the benefits of a more “competitive” financial sector. Moreover, the Asian financial crisis, which was widely perceived to have been exacerbated by financial deregulation, had raised strong doubts about neoliberal policies in regulatory circles – doubts cited by the BCBS as a key motivation for strengthening Basel I (BCBS 1999, p.4). Indeed, some scholars have gone as far as to call the crisis “the last gasp of neoliberalism as a coherent ideology” (Braithwaite 2005, p.5).

A more compelling explanation for Basel II’s bias toward large international banks is the timely participation of these institutions in the regulatory process, an advantage derived from access to the BCBS’s ISN. Particularly close to regulators was the Institute of International Finance (IIF), a powerful Washington-based lobby group representing the world’s largest and most technically sophisticated banks. The longest-serving chairman of the BCBS, the Bank of England’s Peter Cooke (1977-88), was himself a co-founder of the IIF.⁶ The BCBS chairman in the mid-1990s, the Bank of Italy’s Tommaso Padoa-Schioppa, was a close associate of IIF managing director Charles Dallara. After meeting at a social occasion in March 1995, the two agreed to establish an “informal discussion” on regulatory issues under “ground rules” of strict confidentiality.⁷ Links with large banks became even stronger under the chairmanship of William McDonough (1998-2003), a head of the New York Federal Reserve who presided over most of the BCBS’s work on Basel II. Another close friend of Dallara’s from his 22-year career in the banking industry, McDonough gave the IIF access to the BCBS from the earliest stages of negotiations for Basel II.⁸ Before negotiations had even begun, the IIF had established a new body – the Steering Committee on Regulatory Capital (SRC) – specifically to advise the BCBS on the forthcoming accord.

Access to the BCBS’s ISN enabled the IIF to place internal ratings on the agenda for Basel II well before other stakeholders became involved in negotiations. As early as November 1997, the IIF was pressing the BCBS for greater recognition of internal risk measurement systems

on the grounds that they were more “risk-sensitive” than Basel I’s fixed weights (IIF 1997). As a result, the 1999 first draft of Basel II discussed the possibility of an A-IRB approach for “some sophisticated banks,” though only a few paragraphs were devoted to the idea (BCBS 1999, p.37). The IIF’s lobbying efforts intensified in early 2000 with the publication of a technical report emphasizing the robustness of internal credit risk models, as well as their effectiveness in maximizing shareholder value (IIF & ISDA 2000). IIF chairman Sir John Bond publicly called for the recognition of internal ratings in order to “[enhance] the competitiveness of banks by bringing individual banks’ capital requirements more in line with actual risks” (Ibison 2000). These efforts soon paid dividends: in mid-2000, the BCBS’s working group on credit risk began informal work with the IIF to fully incorporate internal ratings into Basel II.⁹ The 139-page second draft accord contained a detailed exposition of the A-IRB approach, which was enthusiastically welcomed by the SRC as one of seven areas in which its recommendations had already been adopted (IIF 2001, p.6).

Other stakeholders only became aware of these developments following the release of the second draft accord in 2001, by which time the BCBS had already invested considerable time and resources in developing the A-IRB approach. The few comments on the draft submitted by small banks reflected serious apprehension about its distributional implications. For instance, America’s Community Bankers (ACB), an association of US community banks, protested that the accord would “benefit only the most complex and internationally active banks, saddling the vast majority of financial institutions in the US with a cumbersome and expensive capital regulatory scheme” (ACB 2001, p.2). Developing countries expressed similar fears, with the Banking Council of South Africa (BCSA) objecting that “bigger, more advanced banks may have access to options that will give them a market advantage, whereas the smaller banks may find it difficult to afford the necessary infrastructure investments” (BCSA 2001, p.4). These objections, however, came too late: by 2001, the costs of discarding years’ worth of technical work on the A-IRB approach were prohibitively high. Indeed, when a group of five major developing countries protested about the accord’s competitive implications at a BCBS meeting in 2002, it was accused by McDonough of attempting to “derail the whole process.”¹⁰ In the end, few changes were made to credit risk approaches between the release of second draft and the publication of the accord in 2004.

Other key parts of Basel II, such as the capital charge covering market risk, tell a similar story.¹¹ Since 1993, the IIF had lobbied the BCBS to allow banks to calibrate market risk using complex mathematical models that produced estimates of “value-at-risk” (VaR) (IIF 1993).¹² Although reluctant at first to consider the use of VaR models, the BCBS began to consider the proposal following the establishment of an informal dialogue with the IIF in early 1995 (see above). Just months later, after intensive technical work with IIF staff, the BCBS published a new 55-page market risk framework fully recognizing the use of VaR models (BCBS 1995). Within a few years, however, the limitations of VaR models were becoming increasingly clear. Indeed, at the very time the BCBS was formulating the first draft of Basel II in early 1999, banks were reporting major losses on Russian government bonds that were entirely unanticipated by their VaR models. Bankers Trust, an American wholesale bank, reported that on five days in the latest quarter trading losses had exceeded its one-day 99 per cent VaR calculation, a figure that statistically should be exceeded on just one day in 100 (Graham 1999). Even more damningly, a report published by the International Monetary Fund (IMF) in December 1998 had condemned VaR models for paying “insufficient attention”

to extreme market events (IMF 1998, p.16). Yet despite such criticism, the BCBS refused to abandon the original market risk charge – a provision in which it had previously invested substantial resources – during negotiations for Basel II.

4.2. *Basel III (2009-11): History repeats itself*

Following the global financial crisis, a consensus emerged in the regulatory community that the basic tenets of Basel II – namely, reliance on internal models and capital relief for the largest banks – had been fundamentally discredited. Growing pressure to revise the accord culminated in the G20's demands at the Pittsburgh Summit in September 2009 for the BCBS to formulate a new set of capital adequacy rules that would form the centerpiece of an "international framework of reform" (G20 2009b, p.8). The BCBS duly complied, releasing a set of preliminary proposals in December that soon became known as "Basel III" (BCBS 2009). Despite the immense political will behind the reform effort, however, large international banks once again managed to seize control of the Basel process. By skewing the provisions of the new accord in their favor, they decisively closed the window of opportunity for far-reaching reform, leaving the global banking system little safer than before the crisis. Why did history repeat itself?

Neither realist nor neo-Marxist approaches provide a persuasive answer. As before, realist theories fail to account for the fact that distributional outcomes primarily reflected the preferences of a transnational group of nonstate actors rather than any particular country within the BCBS. Neo-Marxist theories, meanwhile, fail to correctly identify the mechanism by which these actors shaped global rules. The commitment by more than 100 countries to adopt Basel III in the coming years – together with the extension of BCBS membership to all G20 countries in March 2009 – rendered threats to leave regulated jurisdictions as non-credible as before the crisis. Indeed, while large international banks have occasionally employed exit threats to avert domestic surcharges on Basel III, there are no recorded instances of these institutions leveraging structural power to influence the accord itself (see Beattie *et al.* 2010). Furthermore, like its predecessor, Basel III was prompted by an international crisis that was widely blamed on the pursuit of neoliberal policies such as financial deregulation (see BCBS 2009, pp.1-3). Similarly to other global regulatory initiatives in the wake of the crisis, therefore, the accord sought an "unambiguous departure" from the "neoliberal ideals of market deregulation, decentralization, and reduced state intervention" (Nesvetailova & Palan 2010, p.823).

A closer analysis of the regulatory process reveals that timely involvement played a crucial role in large banks' success in influencing Basel III. In line with TEN theory's expectations, informal social links with BCBS deriving from the exchange of personnel with high levels of technical expertise were a key source of first-mover advantage. A prominent member of the BCBS during the drafting of Basel III, the New York Federal Reserve's Marc Saidenberg, was head of regulatory policy at Merrill Lynch and a member of the IIF Committee on Market Best Practices until 2008. As recently as October 2007, the month Merrill Lynch announced a record \$7.9bn loss, Saidenberg was lobbying regulators to "avoid a knee-jerk reaction to recent events" (Callan *et al.* 2007). Ex-members of the BCBS, meanwhile, moved in the opposite direction. During negotiations for Basel III, Roger Ferguson, formerly of the Federal Reserve's Board of Governors, sat on the IIF's board of directors; Darryll Hendricks, formerly

of Federal Reserve Bank of New York, chaired the IIF Working Group on Valuation; and Patricia Jackson, formerly of the Bank of England, chaired the IIF Working Group on Ratings. In perhaps its greatest coup, the IIF managed to recruit Jacques de Larosière, a former governor of the French central bank and author of a widely read European Commission report on the lessons of the crisis for European financial regulation, to head its Market Monitoring Group (see De Larosière Group 2009).

Table 1. Regulatory preferences and distributional outcomes in the BCBS

Provision	Accord	Preference of first movers (large international banks)	Preference of second movers	Final rule
Internal Ratings	Basel II (1999-2004)	Recognize internal credit risk models used by large banks	Maintain fixed asset risk weights for all financial institutions	Recognition of internal ratings for large banks
Market risk	Basel II	Recognize internal VaR models for calibrating market risk	Prohibit the use of VaR models since they underestimate “extreme” market events	Recognition of VaR models in 1996 (and retention in Basel II)
Total minimum capital ratio	Basel III (2009-2011)	Keep new minimum capital ratio low to avoid undermining economic recovery	Significantly raise total capital requirements	Minimum ratio increased from 2 percent to 4.5 percent
Capital surcharge for systemic institutions	Basel III	Keep surcharge low; ensure that it is nonbinding	Impose binding surcharge on large financial institutions	Surcharge made nonbinding; set between 1.5 percent to 3 percent

Access to the BCBS’s ISN enabled large international banks to enter negotiations at the crucial agenda-setting stage, guaranteeing them an enduring influence over the shape of the accord. Perhaps the clearest example of this influence can be found in Basel III’s overall minimum capital ratio. Within months of the release of the December 2009 reform proposals, major banks were already releasing alarmist estimates of the economic damage that increased capital levels would entail (see JP Morgan 2010). According to the most widely cited estimate, produced by the IIF in a June 2010 report, a 2 percent increase in capital requirements would cut cumulative economic output by 3.1 percent in the Eurozone, the US,

and Japan by 2015, wiping out nine million jobs (IIF 2010). Although this calculation was not confirmed by independent analysis – the BCBS’s own impact study suggested that output would fall by just 0.38 percent – regulators responded by rejecting a significant increase in capital levels (BCBS & FSB 2010).¹³ With amended definitions of capital, the minimum Core Tier 1 ratio would rise from 2 percent to 4.5 percent, less than half of the equivalent ratio maintained by large banks before the crisis (BCBS 2010b).¹⁴ Economists at the Bank of England later admitted that a “huge mistake was made in letting banks come to have much less equity funding...than was normal in earlier times” (Miles *et al* 2011, p.37). Despite these regrets, the BCBS refused to invest any further resources in the calibration of minimum capital requirements under Basel III.

While the BCBS sought to raise minimum standards, it did not question Basel II’s model-based approach to risk weighting – an approach that enabled large banks to significantly understate their true exposure to credit risk the run-up to the crisis (Admati & Hellwig 2013, p.177). It is no coincidence that in July 2009 – months before reforms began to take shape – the IIF released a report demanding that any changes to capital standards be made “within the framework of the Basel II risk-based approach” (IIF 2009, p.26). Opposition to the continued use of internal ratings came too late to count. In its April 2010 comments on the reform proposals, the World Council of Credit Unions (WOCCU), an organization representing 54,000 credit unions, argued that “less reliance on the internal ratings-based approaches” was needed to avoid future bailouts of major banks (WOCCU 2010, p.3). The Independent Community Bankers of America (ICBA), an association representing 5,000 community banks, took an even stronger line, arguing that large banks “should be subject to a more rigorous set of leverage and risk-based capital requirements than other institutions and that are not determined by the institutions themselves based on internal risk-ratings formulas” (ICBA 2010, p.3). By the time the BCBS received these comments, however, it could scarcely afford to overhaul its reform package – a document that had consumed several months of technical work and contained more than 120 pages of detailed provisions.¹⁵

Nor did other key provisions of Basel III, such as the proposed capital surcharge on systematically important banks, escape the timely influence of large banks. As usual, the IIF was first to voice its concerns about the surcharge, warning on the eve of the Pittsburgh Summit against “setting up artificial categories of systemic firms” and stressing that any measures to address systemic risk should be nonbinding (IIF 2009, p.5). Unsurprisingly, the banking industry was not united in its opposition to the measure: smaller banks, seeking to neutralize the capital advantage enjoyed by A-IRB banks, strongly supported a binding surcharge for large banks. WOCCU, for instance, argued that the interconnectedness of A-IRB banks “demands higher, not lower, capital requirements for large financial institutions, as the current calibration of Basel II suggests” (WOCCU 2010, p.2). Yet before such banks had even registered their support a binding surcharge – the end of the comment period in April 2010 – the BCBS had already spent months developing approaches for incorporating it as a nonbinding measure.¹⁶ Fears that the surcharge would be nonbinding were confirmed in July, when the BCBS announced that it would require a “guided discretion” approach to setting capital requirements for systemic institutions (BCBS 2010a, p.5). The calibration of the measure proved equally favorable to large banks: despite suggestions by Federal

Reserve economists that the surcharge should constitute up to 7 percent of risk-weighted assets, in June 2011 the BCBS set it within a range of just 1.5-3 percent (BCBS 2011).

5. Global financial reporting standards

The second test case for TEN theory is the IASB, the transnational regulatory regime responsible for developing financial reporting standards for companies across the globe. Financial reporting standards specify how assets, liabilities, income, expenses, and other transactions and events should be defined and recorded in corporate financial statements. These standards create financial statements that contain comprehensive, transparent, and comparable information about companies' financial positions. In doing so, they facilitate investment and trade as well as shaping business incentives in areas as diverse as executive compensation, corporate financing, mergers and acquisitions, and research and development. In short, they "affect all sectors of the economy and are central to the stability of a country's financial system" (Büthe & Mattli 2011, p.1).

Naturally, the harmonization of financial reporting standards has yielded considerable economic benefits for firms and investors around the world. These benefits, however, have not been distributed evenly. Auditing firms in Anglo-Saxon countries have consistently succeeded in ensuring that global standards reflect the emphasis of their domestic accounting systems on measuring transactions at "fair value" – that is, current market prices. The global regulatory shift toward fair value accounting has, in turn, provided these firms with lucrative opportunities to expand their market share in regions that had previously recorded most transactions at historical cost, such as continental Europe.¹⁷ By contrast, firms in the latter regions, whose national accounting standards diverge from those adopted by the IASB, have been forced to pay considerable "switching costs" in order to comply with global rules. In addition to learning how to interpret information reported under the new rules, they have had to invest large sums overhauling their accounting systems and recalibrating lending agreements, compensation schemes, and investment plans. In short, the global harmonization of accounting standards has created clear winners and losers.

What explains these uneven distributional effects? Realists emphasize the magnitude of Anglo-Saxon nations' capital markets, which has enabled them to pressure access-seeking foreign firms into adopting their domestic standards (Simmons 2001). Yet in terms of size, capital markets in Anglo-Saxon countries have been matched – and on some measures exceeded – by those in continental Europe for several years.¹⁸ Neo-Marxists would highlight the structural and ideological influence wielded by global auditing firms based in Anglo-Saxon countries. While more promising, however, this explanation has major shortcomings. First, since auditors provide (substitutable) services rather than investing or lending, they can inflict only limited economic damage on governments that refuse to adopt their favored rules. Second, even if exit threats were effective at the national level, they would not be credible at the global level: as of 2010, more than 120 countries had adopted the IASB's International Financial Reporting Standards (IFRS). Finally, neoliberalism does not have clear implications for the debate between fair value and historical cost accounting. As discussed shortly, Anglo-Saxon firms' strategy for influencing IFRS relied less on indoctrinating the IASB with a particular economic philosophy than convincing it to delegate

key tasks to them at the crucial agenda-setting and planning stages of the standardization process.

As this suggests, a more persuasive explanation for the distributional effects of global accounting standards lies in the ability of Anglo-Saxon auditors to consistently secure first-mover position in IASB negotiations. The source of this advantage can be traced back to the very first incarnation of the IASB, the Accountants International Study Group (AISG), a forum of British, American, and Canadian standard-setters established in 1966 to examine differences between national accounting rules. Since rulemaking had traditionally been delegated to the accountancy profession in Anglo-Saxon countries, the AISG was mostly comprised of professional auditors. In 1973, the AISG invited standard-setters from six other countries to join it in establishing the International Accounting Standards Committee (IASC) – the IASB’s predecessor – which explicitly aimed to develop global standards. Despite its enlarged membership, the IASC was equally dominated by Anglo-Saxon firms, in particular the Big Six of Arthur Andersen, Coopers & Lybrand, Deloitte & Touche, Ernst & Young, Peat Marwick Mitchell, and Price Waterhouse. No less than eight of the IASC’s 12 chairmen were partners in one of the Big Six. In addition, “[t]he greater part of the IASC’s experts that took part in the steering committees and on the IASC’s staff as project managers had their ordinary employment at one of the six major accounting firms” (Hallström 2004, p.92).

The influence of major accountancy firms in the IASC expanded yet further in 1993 with the establishment of the Group of Four plus One (G4+1), a forum for discussing major standardization projects comprising standard-setters from Australia, Canada, the UK, and the US (plus an observer from the IASC). Between 1994 and 2000, the G4+1 evolved from “think tank” to “embryonic standard-setter,” publishing 12 papers – many of which resembled fully-fledged standards – that guided the IASC’s work on a variety of complex accounting topics (Street 2006, p.116). As we will see in the following subsections, these papers also played a crucial role in the development of IFRS.

Following the IASC’s decision to restructure itself in 1998 – a move aimed at enhancing its ability to develop high-quality global standards – G4+1 standard-setters exploited their collective bargaining power to ensure that members of the new regime would be selected solely on the basis of technical accounting expertise, an asset highly concentrated in Anglo-Saxon auditing firms. Consequently, no fewer than eight of the IASB’s 14 original members had been previously employed by one of the Big Six – a majority large enough to approve the adoption of a global standard under the board’s new constitution. Four of these eight members had also participated in G4+1 meetings, including the group’s first chairman Sir David Tweedie, a former KPMG partner and head of the British Accounting Standards Board (ASB), who served as chairman of the IASB from its establishment in April 2001 until June 2011. Accountancy firms were also strongly represented in the IASB’s auxiliary bodies. All of the Big Four auditors that have dominated global accounting since the early 2000s – Deloitte, PricewaterhouseCoopers (PwC), Ernst & Young, and KPMG – were members of both the International Financial Reporting Interpretations Committee (IFRIC), which issues authoritative guidance on conflicting interpretations of IFRS, and Standards Advisory Council (SAC), the IASB’s advisory body.¹⁹

The concentration of technical expertise in Anglo-Saxon auditors has opened up several avenues for informal interaction between these firms and the IASB. Board members hold

regular off-the-record consultations with the firms' specialized IFRS teams, using them as a "sounding board" for new projects.²⁰ After projects are approved, these teams are often delegated the further task of drafting, editing, and proofreading the text of discussion papers and IFRS. Anglo-Saxon auditors also form the core of the "Expert Advisory Panels" frequently convened by the IASB to assess whether additional regulatory guidance is needed in a given area of accounting.²¹ Perhaps most importantly, these firms provide a large proportion of the IASB's technical staff through an institutionalized secondment system. Under this system, firms pay for senior managers to work at the IASB as "Practice Fellows" for a period of 1-2 years. Although nominally independent, secondees have strong incentives to promote their employers' preferences in IASB working groups and steering committees.²²

In the remainder of this section, I illustrate how membership in the IASB's exclusive ISN has enabled Anglo-Saxon auditing firms to shape three of most important standards adopted by the IASB during the past decade: IFRS 9 *Financial Instruments*, IFRS 3 *Share-Based Payment*, and IFRS 2 *Business Combinations*.

5.1. *Financial instruments*

Since its establishment, the vast majority of the IASB's work has been devoted to revising International Accounting Standards (IAS) inherited from the IASC. Perhaps the fiercest distributional battle over the revision of an existing standard concerned IAS 39, which dealt with the measurement and recognition of financial instruments. The first attempt to develop a standard governing financial instruments was made in the late 1990s. Under pressure to finalize a set of "core standards" in order to gain the endorsement of the International Organization of Securities Commissions (IOSCO), the IASC had hastily adopted an interim financial instruments standard – IAS 39 – under which some financial instruments were measured at fair value while others were measured at historical cost (IASC 1998).

To ensure that any long-term solution reflected its preferences for a full fair value approach, the G4+1 established an independent committee – the Joint Working Group of Standard Setters (JWG) – to develop a permanent version of IAS 39. Despite including a handful of standard-setters from continental Europe, the JWG was dominated by large accountancy firms: more than half of the JWG's 20 members – including both its chairman and project manager – were current or former employees of the Big Four.²³ As expected, the JWG's draft permanent standard, outlined in a lengthy report published in December 2000, permitted the "measurement of virtually all financial instruments at fair value" (JWG 2000, p.i).

Following the transition to the IASB in 2001, major accountancy firms had little difficulty ensuring that the JWG's draft standard became the basis for proposed revisions to IAS 39. Indeed, the IASB's official project manager for amendments to IAS 39 – Sandra Thompson, a former project director at the UK ASB – was herself a key contributor to the JWG's draft standard (JWG 2000, p.300). Furthermore, three of the JWG's most senior members – Tricia O'Malley, Tatsumi Yamada, and James Leisenring – were now members of the IASB. Most stakeholders only became aware that the IASB had adopted the JWG's suggestions following the publication of the first exposure draft for amendments to IAS 39 in June 2002.

The 337-page draft, which had taken officials more than a year to write, allowed entities “to measure any financial asset or financial liability at fair value” (IASB 2002a, p.130).

Unsurprisingly, the proposal encountered stiff resistance from continental European stakeholders – in particular banks – who had traditionally measured financial instruments at historical cost. The French Banking Federation (FBF), for instance, denounced the full fair value approach as “dangerous” and “self-defeating,” predicting that it would result in “an increase, not economically justified, of the volatility of the balance sheet and profit and loss account, which produces inaccurate information in the financial statement” (FBF 2002, p.1). As opposition mounted, in July 2003 French president Jacques Chirac took the unprecedented step of writing to EC president Romano Prodi to warn him of the proposal’s “nefarious consequences for financial stability” (Dombey *et al.* 2003). Yet even high-level political intervention could not alter the IASB’s trajectory, and only minor changes were made to the original draft over the following two years. As the European Commissioner for Internal Market and Services later admitted, “The banks [in Europe]...engaged in discussion on the issue far too late” (Bolkestein 2004).²⁴ Unable to defend their interests in IASB negotiations, European banks persuaded the EC to “carve out” the full fair value option from the 2004 Commission Regulation translating IAS 39 into EU law – a move condemned by businesses for jeopardizing harmonization efforts (EC 2004). Under pressure to abolish the exception, one year later the EC adopted a slightly modified version of IAS 39 published by the IASB in 2005 that continued to allow fair value measurement in most circumstances (EC 2005).²⁵

Controversy over IAS 39 was reignited during the global financial crisis, in which fair value accounting was widely regarded as having exacerbated illiquidity in securities markets. In March 2009, the G20 Working Group on Enhancing Sound Regulation and Strengthening Transparency emphasized the need to “dampen the adverse dynamics associated with fair value accounting,” a message echoed in the G20 leaders’ recommendation in April to “improve standards for the valuation of financial instruments” (G20 Working Group 1 2009, p.iii; G20 2009b, p.5). Yet one year earlier – in a discussion paper drafted in part by auditing firms – the IASB had already concluded that “[f]air value seems to be the only measure that is appropriate for all types of financial instruments” (IASB 2008, p.4).²⁶ Subsequent amendments to IAS 39 consequently contained no further restrictions on the use of fair value measurement.²⁷ To the contrary, the first part of IAS 39’s successor standard IFRS 9, which was issued by the IASB in November 2009, *expanded* the application of fair value by requiring new types of embedded derivatives and financial liabilities to be valued at market prices (IASB 2009). EC officials, who were said to be “furious” that they had not been given due weight in negotiations, refused to endorse IFRS 9 until the remaining parts of the standard had been finalized.

5.2. Share-based payment

Timely participation by accountancy firms played an equally important role in shaping the IASB’s treatment of share-based payment transactions – that is, transactions in which payment takes the form of granted shares, share options, or share appreciation rights. Traditionally, few accounting systems provided guidance on such transactions, allowing businesses to keep expensive employee share plans out of their financial statements. In the

late 1990s, major auditing firms convened a working group under the auspices of the G4+1 to explore the possibility of harmonizing accounting rules on share-based payment. The working group was headed by two project directors at the UK ASB with close links to the auditing firms: Kimberley Crook, a secondee from the London branch of PwC; and Kathryn Cearns, a former employee of Ernst & Whinney (later Ernst & Young). The main conclusions of the working group, which were published in an IASC discussion paper in July 2000, were that (1) share-based payment transactions should be recognized in financial statements; and (2) the “appropriate measurement basis for such transactions is the fair value of the shares or options issued” (IASB 2000, p.7).

Following the release of the report, share-based payment quickly found its way to the top of the newly established IASB’s agenda. In a now-familiar pattern, the IASB selected former PwC employee Kimberley Crook – the principal author of the G4+1 discussion paper – to lead its standardization project on share-based payment. Unsurprisingly, the lengthy exposure draft for the new standard, which was circulated for comment in November 2002 following several months of technical work, embraced both of Crook’s earlier recommendations. As draft’s introduction states, “The objective of [the draft standard] is to ensure that an entity recognizes all share-based payment transactions in its financial statements, measured at fair value, so as to provide high quality, transparency, and compatible information to users of financial instruments” (IASB 2002b, p.16).

While receiving strong support from large auditing firms, the exposure draft provoked a furious reaction from businesses across Europe (see PwC 2003). The European Financial Reporting Advisory Group (EFRAG), a private-sector organization established in 2001 to provide advice to the EC on the technical quality of IFRS, emphasized the “great concern among our constituents that all share purchase plans would be automatically scoped in by the proposed standard,” and argued that the blanket application of fair value to share-based payment transactions was “too restrictive” (EFRAG 2003, pp.2-3). The European Employee Stock Options Coalition (EESOC) was even more critical, arguing that the draft “is inconsistent, technically flawed, leaves some important implementation questions unanswered and would, if adopted, impair the credibility of reported numbers by reducing comparability and introducing an opacity to the accounts” (EESOC 2003, p.1). As with IAS 39, however, these objections were submitted too late for the IASB to consider relinquishing its extensive earlier work on the proposal. In November 2004, the exposure draft was adopted virtually unchanged as IFRS 2 *Share-based Payment* (IASB 2004a).

5.3. Business combinations

The development of global accounting rules governing business combinations (mergers and acquisitions) provides a further example of the success of auditing firms in obtaining their favored distributional outcomes by securing first-mover advantage in the standard-setting process. In the late 1970s, accountancy firms persuaded the IASC to establish a steering committee under the chairmanship of John Bishop, a partner in the Australian branch of Peat Marwick Mitchell (later KPMG), to assess the scope for reconciling national accounting rules on business combinations. These firms were particularly keen to rein in the use of the pooling-of-interests method of accounting for acquisitions, which requires that two businesses’ assets and liabilities are combined at their book values following an

acquisition.²⁸ Under their favored option – the purchase method – balance sheets are amalgamated at market values. The standard that emerged from the committee's deliberations in June 1983, IAS 22, clearly reflected preferences of accountancy firms: the purchase method was required for the vast majority of business combinations, with pooling-of-interests accounting allowed only in "rare circumstances" (IASC 1983).

Table 2. Regulatory preferences and distributional outcomes in the IASB

Provision	Standard	Preference of first movers (Anglo-Saxon auditing firms)	Preference of second movers	Final rule (IFRS)
Financial instruments	IAS 39/IFRS 9	Measure all financial assets and liabilities at their fair value i.e., their current market prices	Maintain a historical cost option for all financial instruments	Instruments measured at fair value under almost all circumstances
Share-based payment	IFRS 2	Recognize share-based payment in financial statements; measure such transactions at their fair value	Exclude some share plans from financial statements; limit the application of fair value	All share plans recognized in financial statements and measured at fair value
Business Combinations	IAS 22/IFRS 3	Abolish the pooling-of-interests method; measure all business combinations at fair value (purchase method)	Maintain pooling-of-interests accounting; do not introduce purchase method	Pooling-of-interests method abolished and replaced by purchase method

During the 1990s, businesses began to circumvent IAS 22's restrictions on the use of pooling-of-interests accounting, which typically "allowed a wide range for interpretation" (Camfferman & Zeff 2006, p.137). In the US, for instance, the share of mergers and acquisitions transactions recorded using the pooling-of-interests method soared from 2 percent in 1992 to 31 percent in 1998 (Boegler & Lewis 1998). In response, accountancy firms assembled a working group of senior accountants from G4+1 standard-setters to draft a comprehensive set of revisions for IAS 22. The working group's main recommendation for revising IAS 22, published in a G4+1 discussion paper in December 1998, was that the pooling-of-interests method should be eliminated entirely. All business combinations, in other words, should be accounted for using the purchase method (G4+1 1998).

In October 2002, as part of the so-called Norwalk Agreement to promote convergence between US GAAP and IFRS, the IASB embarked on a joint project with the FASB to develop a successor standard to IAS 22. The IASB-FASB exposure draft for the new standard (ED3), published in December 2002, incorporated the G4+1's recommendation

almost word-for-word, proposing “to eliminate the use of the pooling-of-interests method and require all business combinations within its scope to be accounted for by applying the purchase method” (IASB 2002c, p.5). This move had been strongly advocated by the FASB, which had followed other G4+1 standard-setting bodies in abolishing pooling-of-interests accounting at the domestic level in June 2001. As *Financial Times* noted at the time, it was clear that companies in continental Europe, where the pooling-of-interests method was still widely used, would be “hardest hit” by the new rules (Smy 2002).

Once again, support for the retention of the pooling-of-interests method from European stakeholders was expressed only after the release of the IASB’s exposure draft, a relatively late stage in the standardization process. The European Roundtable of Industrialists (ERT), which represents the interests of around 50 major European multinational companies, criticized the draft as “arbitrary” and “inappropriate,” arguing that “the cost of acquisition has to be retained because it is the best way to measure the net assets acquired” (ERT 2003, pp.1-2). Mazars, a French accountancy firm, expressed a similar view, arguing that in the case of mergers between similarly sized companies “the purchase method [does not give] a true and fair view of the economic substance of the new entity resulting from the combination” (Mazars 2003, p.5). Other European stakeholders, such as the French bank BNP Paribas, missed the deadline for submitting comments altogether. Consequently, in March 2004 the exposure draft was adopted by the IASB with minimal changes as IFRS 3 *Business Combinations* (IASB 2004b).

6. Conclusion

During the past three decades, the transnational regulatory space in finance has played host to some of the most intense distributional battles waged in any area of global governance. I have argued that issue-specific characteristics of international finance – most notably, its high degree of technical complexity – have played a critical role in shaping the outcome of these battles. By influencing access to regulators’ ISNs, my TEN theory suggests, such characteristics have been instrumental in determining which stakeholders secure first-mover position and thus set the agenda in global financial rulemaking. Moreover, by giving rise to a dynamic of increasing returns, they have ensured that proposals made at an early stage of rulemaking are highly resistant to change at later stages, guaranteeing that first movers enjoy greater influence over international standards than second movers. A detailed process-tracing analysis of distributional conflicts waged within two major transnational regulatory regimes in finance – the BCBS and the IASB – has provided empirical evidence for the theory.

Given the importance of equitable financial rules for the health of the global economy, it is instructive to reflect on the implications of TEN theory for the design of transnational regulatory regimes in the financial sphere. The theory suggests at least four principles for designing regimes that are accountable to a wide range of financial stakeholders:

- (1) Regimes should maintain a clear distance from the finance industry to prevent informal social links between officials and regulated interests from becoming too strong. Such a separation could be achieved by placing restrictions on the “revolving door” between rulemaking bodies and private institutions or actively seeking to

expand the range of backgrounds from which officials are recruited (Carpenter & Moss 2013). Regimes should also limit the number of secondees, interns, and temporary staff they hire from the private sector.

- (2) Regimes should minimize information asymmetries regarding the regulatory agenda at each stage of the regulatory process. To this end, officials should conduct regular consultations with a broad range of public and private actors – akin to a process of “negotiated rulemaking” at the global level – and ensure that new initiatives are widely publicized (Auld *et al.* 2013). Such measures would help to bring about a more equitable distribution of regulatory capabilities among stakeholders.
- (3) Regimes should avoid delegating crucial regulatory functions to stakeholders. To safeguard officials’ operational independence, standard-setting bodies must be given the financial resources and administrative support necessary to attract high-quality technical expertise and to conduct in-depth research into complex regulatory issues. Where delegation cannot be avoided, regimes should divide functions among several stakeholders to prevent narrow interests from monopolizing regulatory capabilities.
- (4) To mitigate the advantage gained by early entry into the regulatory space, regimes should be subject to robust oversight mechanisms. Regimes must be held to account both by the international bodies that have delegated authority to them and by national governments through domestic ratification. They should also introduce procedures to improve compliance with internal directives (similar to the World Bank Inspection Panel) and to allow stakeholders to question their success in terms of their own goals.

To be sure, translating these principles into concrete regulatory reforms is not a simple task. Each principle can be realized through several different design features, and it is only via a time-consuming process of institutional trial and error that we can assess which combination of features is most effective. In addition, reform efforts are likely to meet strong political opposition from actors profiting from the regulatory status quo, whether large international banks or Anglo-Saxon auditing firms. Yet the analysis presented in this study suggests that the benefits of enhancing the accountability, inclusiveness, and legitimacy of the regulatory regimes governing the global financial system would more than justify the costs.

Notes

¹ Rulemaking is itself just one of many stages that comprise the overall process of global regulation. Other stages include implementation, monitoring, and enforcement (Mattli & Woods 2009).

² Large set-up costs were first identified as a source of increasing returns by economic historians studying the spread of knowledge-intensive technologies (Arthur 1994; David 1994).

³ Indeed, such regimes typically involve a distinct ratification phase in which governments consult with constituents about whether to endorse rules agreed during earlier negotiations.

⁴ The evidence presented in this section draws on the more detailed case studies in Lall (2012).

⁵ Core Tier 1 capital mostly consists of equity; Tier 1 consists of Core Tier 1 plus disclosed reserves; Tier 2 capital consists of undisclosed reserves, loan-loss provisions and subordinated debt.

⁶ Author's interview with Peter Cooke, former BCBS chairman, Oxford, November 2008.

⁷ Author's interview with Oliver Page, former BCBS member, London, December 2008.

⁸ Author's interview with Patricia Jackson, former BCBS member, London, December 2008.

⁹ Author's interview with William McDonough, former BCBS chairman, Washington D.C., January 2009.

¹⁰ Author's interview with BCBS observer, Washington D.C. January 2009.

¹¹ Market risk is "the risk of losses in on- and off-balance-sheet positions arising from movements in market prices" (BCBS 2004a, p.157).

¹² VaR represents the probability that losses on a portfolio of assets will exceed a certain amount within a given time horizon, for example \$1 million over the next 10 days.

¹³ Author's interview with BCBS member A (Bank of England), London, February 2010.

¹⁴ Author's calculation using information in annual reports. All of the world's largest 10 banks had ratios of equity to risk-weighted assets (an even narrower Core Tier 1 ratio) of above nine percent in 2007.

¹⁵ Author's interview with BCBS member A (Bank of England), London, February 2010.

¹⁶ Author's interview with BCBS member B (Bank of England), London, February 2010.

¹⁷ Despite traditionally conducting much of their business in the US, as of 2012 the Big Four derived the largest share of their global revenues – 43 percent on average – from Europe (Big4.com 2013, p.2).

¹⁸ According to recent IMF data, the value of bonds, equities, and bank assets is almost \$20 trillion higher in the EU than in the US (IMF 2012, Appendix p.11).

¹⁹ The Big Six became the Big Four following the merger of Coopers & Lybrand with Price Waterhouse to form PwC in 1998 and the collapse of Arthur Andersen in the wake of the Enron scandal in 2002.

²⁰ These discussions are also an important source of information about the IASB's agenda for auditing firms. As one partner of a Big Four firm revealed: "Although the IASB eventually publishes its agenda, we usually learn about new standardization projects in advance through private discussions with board members and staff." Author's interview with Deloitte partner, London, August 2012.

²¹ Author's interview with KPMG partner A, London, August 2012.

²² Author's interview with KPMG partner B, London, August 2012.

²³ Interestingly, a further two members – Patricia Stebbens and Shigeo Ogi – would be made partners at the Big Four shortly after the JWG's disbandment.

²⁴ Representatives of EU member states, such as the German state secretary for economics Caio Koch-Weser, also lamented that Chirac's intervention came "too late" to alter the IASB's decision (Dombey 2003).

²⁵ Specifically, it allows firms to use fair value when there is an “accounting mismatch” between the measurement of assets and liabilities and when financial instruments are managed in accordance with a documented risk management strategy (IASB 2005).

²⁶ Author’s interview with KPMG partner A, London, August 2012.

²⁷ In October 2008, however, the IASB issued amendments to IAS 39 allowing firms to temporarily reclassify instruments out of the fair value category in “rare circumstances” such as the ongoing turmoil (IASB 2008, p.5).

²⁸ The book value of an asset is its historical cost minus any depreciation, amortization, or impairment costs made against it.

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