The Comparative Political Economy of Basel III in Europe

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Abstract

The Basel III Accord was the centerpiece of the international regulatory response to the global financial crisis, setting new capital requirements for internationally active banks. This paper explains the divergent preferences on Basel III of national regulators in three countries that approximate what are frequently presented as distinct varieties of capitalism in Europe – Germany, the United Kingdom and France. It is argued that national regulators faced a 'trilemma' in setting capital requirements, having to prioritize among banking sector stability, the competitiveness of national banks and short to medium term economic growth. Different varieties of national financial system – specifically, banking system and different kinds of 'banking champions' – explain the different prioritization of objectives in the 'trilemma' and hence for the divergent preferences of national regulators on Basel III capital requirements.

Keywords: Capitalism, varieties of, finance, regulation
JEL classification: G21 Banks, G28 Government policy and regulation, P16 Political Economy

1. Introduction

The Basel III Accord on a 'Global regulatory framework for more resilient banks and banking systems' issued in late 2010 was the cornerstone of the international regulatory response to the global financial crisis. The accord was designed to set capital requirements for banks worldwide. Capital requirements have traditionally been regarded as the main instruments to ensure the stability of the banking sector. In 1988, the Basel Committee on Banking Supervision (BCBS) issued the Basel I Accord on 'International convergence of capital measurement and capital standards' (Kapstein, 1989, 1992; Simmons, 2001), which was updated by the Basel II Accord in 2004 (Tsingou, 2008; Underhill and Zhang, 2008; Wood, 2005). Over time, these ‘soft’ international rules have been incorporated into (legally binding) national legislation in more than 100 countries. In the European Union (EU) this has been done through the capital requirements directives (Underhill, 1998; Howarth and Quaglia, 2013).[1]

This paper explains the divergent preferences of the national regulators of three main European countries – Germany, the United Kingdom and France – on Basel III. These countries are selected principally because they are the largest financial, and specifically banking, systems in Europe and, with the United States, China and Japan, they are among the six largest in the world. They are also selected because, in the Varieties of Capitalism literature, Germany and the UK are frequently presented as the closest European approximations of distinct varieties – Germany, the Coordinated Market Economy; the UK, the Liberal Market Economy (Hall and Soskice, 2001); while France – a unique hybrid – is presented as a post-State-led, ‘Mixed Market’ or even State-enhanced economy (Schmidt, 2003). The US is not included in this analysis because the main purpose of the paper is not to explain the outcome of Basel III negotiations, but rather to map the configuration of the three largest national financial systems in Europe and explain how this configuration influenced the preferences of national regulators on the capital requirements they agreed at the international level.

This paper first argues that national financial regulators face a ‘trilemma’ as they seek to achieve and prioritize three different objectives: financial stability, bank competitiveness and economic growth. Existing political economy scholarship on international financial cooperation has mainly focused on the ‘dilemma’ between financial stability and competitiveness of the national financial industry. Rather surprisingly, it has missed an important element of consideration: the link between financial regulation (here capital requirements), the flow of credit to the real economy and ultimately economic growth. By explaining the trilemma, this research brings insights from Comparative Political Economy into a topic of research – banking prudential regulation – traditionally dominated by International Political Economy.

Second, this paper shows how the preferences of European national regulators on Basel III are the result of the domestic political economy (for a similar argument that focuses more broadly on national political economies see Fioretos, 2010). However, one needs to look at domestic institutional factors that are often overlooked (or not investigated) by the literature on Varieties of Capitalism, namely the configuration of the national financial system and, more specifically, the national banking system. By carrying out a comprehensive analysis of national banking systems in the UK, France and Germany and outlining their main relevant features, this paper fills a gap in the literature on Varieties of Capitalism. It also explains how different national banking / financial systems result in different priorities assigned by national regulators to the three objectives of the 'trilemma' on banking regulation and capital requirements more specifically. This paper thus develops a predictive framework that can be applied to explain other national positions on international capital standards and, potentially, other areas of banking regulation.

2. State of the art and theoretical framework

In much of the literature, the assumption is that international regulatory cooperation benefits some countries more than others, affecting the competitiveness of national firms – it has therefore redistributive implications (Oatley and Nabors, 1998). Consequently, international regulatory cooperation and harmonization will take place only when they are in line with the preferences of the main jurisdiction, which in the past was the US because of the size of its domestic market (Simmons, 2001). Recently, International Political Economy scholars have considered the preferences and power of other jurisdictions with large domestic markets (Drezner, 2007). In this literature, policy makers' preferences are shaped by concerns for the competitiveness of national banks in international markets, and by the need to ensure financial stability domestically (Singer, 2004, 2007). This is the 'dilemma' of financial regulators (Kapstein, 1989).

This paper argues that, rather than a 'dilemma', regulators face a 'trilemma' in their policy making on financial regulation: financial stability, competiveness of financial industry and economic growth, because banks and banking rules have implications for credit to the real economy. Policy makers have to prioritize among these three objectives and their ranking of objectives largely depends on the national variety of financial capitalism. Hence, our use of the term 'trilemma' differs from the financial trilemma of Dirk Schoenmaker (2013), which examines the interplay of financial stability, international financial integration (notably, cross-border banking) and national financial policies. He argues that any two of the three objectives can be combined but not all three: one has to give. Our trilemma is not conceived in such exclusionary terms: no objective is entirely discarded to achieve the others. Rather, the compatibility of the three objectives of our trilemma can be difficult, optimizing all three objectives at the same time impossible and an order of priority must be set.

A second stream of literature focuses on the pervasive power of big transnational banks, which are influential lobbyists with plenty of financial, human and technical resources at their disposal (Baker, 2010; King and Sinclair, 2003; Tsingou, 2008; Underhill and Zhang, 2008; Underhill *et al.*, 2010). Building on these insights, Lall (2012, p. 7) argues that Basel II and Basel III were 'the product of regulatory capture by large international banks in G-10 countries'. By contrast, Young (2012, p. 663) qualifies the extent of 'regulatory capture' in Basel II, arguing that while private sector lobbyists had easy access to the regulatory process, this 'access' did not always mean 'influence' over the outcome. Yet, this literature often does not explore the underlying foundations of financial industry preferences, as our paper sets out to do.

Third, social constructivist works on the institutional features and working dynamics of a number of international financial regulatory bodies argue that financial governance arrangements no longer belong to the realm of intergovernmental negotiations but fall within the responsibility of a 'transnational policy community of experts actors' (Tsingou, 2010, p. 21). These actors have common professional and educational backgrounds (Chiewroth, 2007) and share similar epistemological views (for example, Kapstein, 1992 defined the BCBS as an embryonic 'epistemic community').

Yet, financial regulation is a technical matter that has significant and different economic and political effects across national banking sectors. In the aftermath of the global financial crisis, financial regulation has become less insulated than in the past from politics and politicians (Helleiner and Pagliari, 2011) – it is no longer 'quiet politics' (Culpepper, 2011). Moreover, the few works that examine the BCBS (e.g., Kapstein, 1989; Simmons, 2001; Wood, 2005) rarely consider its actorness, but rather examine it as an international forum of national regulators, who act in the Committee as 'reluctant diplomats' (Slaughter, 2004). This is because, unlike for example the International Monetary Fund (IMF) or the World Bank (Chiewroth, 2007; Moschella, 2012), the BCBS has a skeletal structure of officials often seconded to Basel by national regulators and has a limited budget. Its working groups are composed of and chaired by national regulators. It works by consensus and issues soft law or gentlemen's agreements.

Feeding into the literature on economic constructivism, some authors have pointed out the rise, prior to the international financial crisis, of the ‘neoliberal’ paradigm (Best, 2003; Gamble, 2009), that is a ‘governance light’ approach, which favoured ‘market-based governance’, based on a benign view of financial markets and grounded in efficient market theories (Mügge, 2011; Underhill *et al.*, 2010, p. 10). In Europe, the UK was the main promoter of ‘light touch’ regulation (Hodson and Mabbett, 2009; Macartney, 2010), which was discredited by the financial crisis. By contrast, France, Germany and Italy had a ‘market-shaping’ approach to financial regulation, which was in good currency in the aftermath of the crisis (Fioretos, 2010; Quaglia, 2010a, b; Zimmerman, 2010), especially in government discourse (Buckley and Howarth, 2010). However, the empirical analysis of the preferences of national regulators on key features of Basel III contradicts this explanation, because the British and US policy makers called for stricter rules on capital, whereas continental Europeans did not support them. Ideas – here set by regulatory paradigms – provide little guidance on national preference formation on Basel III.

There is a literature exploring how domestic policy making / institutional frameworks shape financial regulatory choices, either through embedded legal frameworks that limit regulatory options (Howarth 2013) or through institutional frameworks that work to reinforce or diminish the influence of specific financial lobbies. In Germany, the federal structure of government and the central role of the Bundesrat (upper house) in law making help to explain the influence of the local savings banks and regional banks (Busch 2004; Deeg 1999). In France, some works highlight the close relationship between administrative elites staffing high-level positions in formerly state-owned banks (Schmidt 1996, Rouban 2010). In the UK, the pervasive influence of the City through specific institutional channels has also been critically examined (James 2014). In a comparative analysis (including France, the UK and Germany), Woll (2014) argues that different types of business–government relations contribute to explaining the way in which the bank bailout packages were devised and implemented across countries (see also Grossman and Woll 2013). These accounts are useful in order to explain how banks influence public policy (or not) – government-bank interactions – but they are less insightful in explaining what either banks or governments want with reference to banking regulation,[2] that is the sources and the content of their regulatory preferences, which we argue here mostly depends on the distinctive features of the national banking system in which they are embedded and bank business models.

Other authors (for example, Pagliari 2013) have pointed to the role of public opinion and the political salience of financial regulation in order to explain the regulatory reforms undertaken since 2008. This explanation, based on the politicization of banking, points out the public antagonism to bankers and banks generated by the crisis, as expressed in opinion polls and the mobilization of groups to counter the influence of banks. Hence, the British government support for higher capital requirements could be explained by greater public outrage at bail-outs (which resulted in part from the size of the bail-out) for 'too-big-to-fail' banks. In France and Germany, the (real and perceived) impact of the crisis was smaller than in the UK (Hardie and Howarth 2013), as was the public backlash against banks. This explanation focused on the domestic politics of financial regulation chimes well with the one developed in this article: the way in which the crisis played out in different countries is partly explained by the distinctive features of the national banking systems (Hardie and Howarth 2013), even though the public authorities' reaction to the crisis was shaped by domestic political dynamics (Woll 2014; Grossman and Woll 2013).

A relatively recent body of work brings insight from Comparative Political Economy and historical institutionalism into International Political Economy (Bach and Newman, 2007, 2010; Büthe and Mattli, 2011; Fioretos, 2001, 2010; Kalinowski, 2013; Posner, 2009, 2010;

Moschella and Tsingou, 2013). The basic argument is that 'domestic regulatory institutions are the sources of both power and preferences on the global stage' (Drezner, 2010, p. 794). The Comparative Political Economy approach adopted in this paper is inspired by historical institutionalism: it considers banking and more generally financial systems as institutions that shape domestic preferences on international agreements. In so doing, the analysis developed in this paper adds to the Varieties of Capitalism literature, examining the financial underpinning of the national variety of capitalism, that is assumed and rarely explored in the literature (for two partial exceptions, see Busch, 2004; Zimmerman, 2010). Our analysis teases out three main features of national financial systems that affect the preferences of policy makers on financial regulation (here capital requirements) and specifically the 'trilemma' they face in deciding whether to prioritize financial stability, bank competitiveness or economic growth.

2.1 Research design

This paper sets out to explain the prioritization of national regulators on the 'trilemma' objectives and their specific preferences on Basel III, which together form a two-stage *dependent* variable summarized in Table 3. The elements of the trilemma, namely stability, competitiveness and the real economy co-exist but they are not interdependent in and of themselves but rather in terms of the impact of selecting one upon the others. For example, if regulators prioritize stability this may have an impact upon the competitiveness of the banking sector (in relation to foreign banks) and upon the real economy (because, ceteris paribus, banks need to deleverage to improve their capital position). However, the prioritization of stability does not suggest a lack of concern for competitiveness and the real economy as objectives. Rather, the argument of this paper is that prioritization is driven by specific features of national banking systems as opposed to the rational interests of regulators.

We focus on national regulators because countries are represented in the BCBS by authorities from central banks or other supervisory bodies. Most of these officials have limited or no power to adopt regulation at the national level but they will always be involved in the drafting of national legislation – and in the political economy literature they are generally referred to as ‘regulators’.[3] National politicians were one step removed from the Basel negotiations. We assume that national regulators were aware that the agreement reached in Basel had to be acceptable to their respective political authorities – notably ministers of finance – back home, but this is not to say that the preferences of national regulators in the BCBS were the same as government leaders. We do not investigate the domestic implementation of Basel III which would involve an analysis of the interaction between regulators and governments / legislatures. We are also aware that treating the preferences of national regulators as monolithic is an oversimplification, especially in the UK, where there was a plurality of actors shaping banking regulation, as noted in Section 3.

Section 3 outlines the content of Basel III and teases out the preferences of regulators, the second part of our dependent variable, during the negotiations on the main issues at stake. The preferences of regulators are understood and analysed through: i) semi structured interviews with members of the BCBS and financial industry officials and representatives in the three countries, at the EU level and in other countries; ii) over a hundred position papers and official public responses to consultations by banking and other associations and individual banks posted on the BCBS website; and iii) a systematic survey of financial press coverage. The debate on the incorporation of Basel III into EU legislation and the legislative outcome are also examined because, on some of the core elements of the Basel III agreement, issues papered over and compromises reached behind the close doors of the BCBS meetings, unravelled during EU negotiations – hence, preferences on specific issues came openly to the fore in the EU debate (IMF, 2011a). The positions of stakeholders (banks) are also considered in this section.[4]

The *independent* variable is the configuration of the national banking / financial system. Specifically, three core features of national banking / financial systems that relate to the national variety of capitalism are examined, namely: internationalization and capital levels of national banking systems, and the relative importance of bank credit to national financial systems. Section 4 examines the configuration of national banking (and financial) systems, explaining how the three core features of national banking systems relate to the trilemma and to regulatory preferences on Basel III.[5] This Comparative Political Economy analysis of the balance sheets of banks in the three countries is enriched by semi-structured elite interviews in order to corroborate some the financial data gathered and better understand the position of banks and regulators. The conclusion discusses the explanatory power of the framework developed here in order to understand the preferences of other national regulators given distinctive banking systems.

3. The Basel III accord and national policy makers' preferences

The BCBS put forward concrete proposals on Basel III in December 2009 (BCBS, 2009a, b), which were then subject to public consultation. Other documents (for example on the countercyclical capital buffer, BCBS, 2010a) were issued for consultation throughout 2010. A general agreement was reached in July 2010 (BCBS, 2010b) and a final agreement was eventually signed in December (BCBS, 2010 e,f). Compared to the Basel II accord, Basel III was negotiated in record time – less than two years – due to the political salience imparted to it by the recent international financial crisis. The Basel III rules are to be phased in gradually from January 2013 until 2019. The accord has to be transposed into national (and / or EU) law in order to become legally binding.

Table 1 summarizes the preferences of British (and by way of comparison American), German and French policy makers on the main elements of Basel III.[6] In a nutshell, UK and US regulators wanted a restrictive definition of capital and higher levels of capital, whereas French and German regulators were keen to have a broader definition of capital and lower capital requirements. UK and US regulators supported a leverage ratio, French and German regulators opposed it and asked for longer transition periods to implement the accord. Let us examine these elements in more detail.

The accord provides for the first time a common definition of capital, on which there had been no agreement in the past. The main form of 'Tier 1 capital' must be common shares and retained earnings. The remainder of Tier 1 capital can include subordinated debt. 'Hybrid capital' instruments should be phased out (BCBS, 2010e, p. 2).[7] Many EU regulators, in particular the Germans, were concerned about the ban on 'hybrid' capital, which would considerably reduce the capital base of their banks that used these and similar non-equity instruments in their calculation of Tier 1 capital (*The Economist,* 23 January 2010). By contrast British and American regulators were keen to exclude hybrids from the definition of capital (interviews, US financial regulators, Washington, 5 August 2011). For example, a senior figure from the British Financial Services Authority noted that '…hybrid capital … acts like debt as far as the tax man is concerned, and … like equity as far as the depositor is concerned. This hybrid capital is junior to deposits, but senior to equity' (Huertas, 2009: 11). British and American regulators insisted that shareholders should take the losses for hybrids rather than the government having to cover it.

Table 1 National policy maker positions on the capital provisions of Basel III

	United Kingdom (and United States)	**France**	**Germany**
Definition of Capital	Ban on hybrids for all tier 1.	Tolerance on hybrids (esp. for non-core tier 1).	Need to include hybrids ('silent participations').
Level of Capital	Higher level needed. Exclude double counting of insurance subsidiary capital.	Full double counting of insurance subsidiary capital.	More cautious and gradual rise; double counting of insurance subsidiary capital.
Leverage ratio	Inclusion. Push for lower ratio than 33.	Exclusion / Or voluntary if included.	Exclusion / Or voluntary if included.
Transition periods	Rapid: by 2015 at the latest.	2015 / 2018 manageable with qualifications intact.	Lengthy: >decade.

The total regulatory capital consists of Tier 1 Capital and Tier 2 Capital and it must be at least 8 per cent of risk-weighted assets.[8] Tier 1 must be at least 6 per cent of risk-weighted assets and the 'Core Tier 1', which comprises common equities, must be at least 4.5 per cent of risk-weighted assets (BCBS, 2010e, p. 12). The original proposals for higher capital requirements were watered down in a search for a compromise between the UK, the US and Switzerland, keen to set higher requirements, and several continental regulators, resisting them and asking for longer transition periods (*Financial Times*, 22 October 2010). Basel III introduces a 'capital conservation buffer'[9] of 2.5 per cent comprised of common equities, above the regulatory minimum. Capital distribution constraints are to be imposed on a bank when capital levels fall within this range (BCBS, 2010e, p. 55). On 'Core Tier 1', therefore, Basel III sets risk-weighted capital requirements of 4.5 per cent as compared to a pre-existing (Basel II) level of 2 per cent, plus a new buffer of 2.5 per cent, establishing a new effective floor at 7 per cent. National countercyclical buffers, designed to take into account the macro-financial environment in which banks operate, are also to be introduced (BCBS, 2010e, p. 57). These buffer requirements, to be decided by national jurisdictions, can vary between zero and 2.5 per cent of risk-weighted assets. Bank specific countercyclical buffers can also be imposed

(BCBS, 2010 e, p. 58). Capital buffers are to be phased in between 2016 and 2019. Basel III also envisages a capital surcharge to mitigate the risk of systemic banks, to be agreed subsequently.

Basel III introduces a 'leverage ratio', which is a non-risk based ratio calibrated to act as a supplementary measure to the risk based capital requirements. The BCBS would test a minimum Tier 1 leverage ratio of 3 per cent during the trial-run period from 1 January 2013 to 1 January 2017 (BCBS, 2010e, p. 61). This regulatory instrument was already in use in the US, but its introduction into Basel III was resisted by most continental European regulators, who argued that the riskiness of the activities of their traditional universal banks was lower than that of (largely Anglo-Saxon) investment banks and that this feature would not be captured by a crude leverage ratio (*Financial Times*, 26 October 2010; interview, French regulator, Paris, 7 July 2011). Having failed to prevent the inclusion of the leverage ratio in the Basel III rules, continental regulators lobbied hard for it not to be included in the European Commission's proposed legislation implementing Basel III.

If one considers the evolution of the negotiations, in its draft issued in December 2009, the BCBS took a surprisingly hard-line approach on capital and liquidity requirements, pushing for a higher adequacy threshold and a restriction on hybrids, with minimum capital to be composed of predominantly equity capital. Given the similarity of preferences of UK and US regulators, their remarkable financial expertise, the large size of their financial sectors and their chairmanship of key working groups,[10] they were able to leave a strong imprint on the initial Basel III draft of December 2009. However, the final December 2010 version was less strict: in particular, it contained longer transition periods. This relaxation owed in part to the extensive lobbying from banks and bank associations but also largely to the resistance of continental European and Japanese regulators to some of the most draconian provisions.

Indeed, at the crucial meeting of the BCBS in September 2010, three months prior to the final agreement, German regulators refused to endorse the document prepared by the BCBS, asking for and subsequently obtaining important revisions (interview, German financial industry representative, Frankfurt, 18 April 2012, BCBS, 2010d).

The preferences of national regulators were not monolithic and different internal views tended to emerge once the accord had been agreed internationally and then had to be implemented domestically. The most notable case was in the UK where Andy Haldane, the Bank of England executive director for financial stability, criticized Basel III which was defended by then Governor Mervyn King. Haldane argued that its rules were too complex. He was a keen supporter of a simple leverage ratio, rather then risk-weighted assets. Deputy governor Paul Tucker, parting ways with both Haldane and King, refused to highlight the ‘Too-Big-To-Fail’ problem and the need to break up big banks (*The Telegraph*, 27 November 2012).

4. National financial systems and the Comparative Political Economy of Basel III in Europe

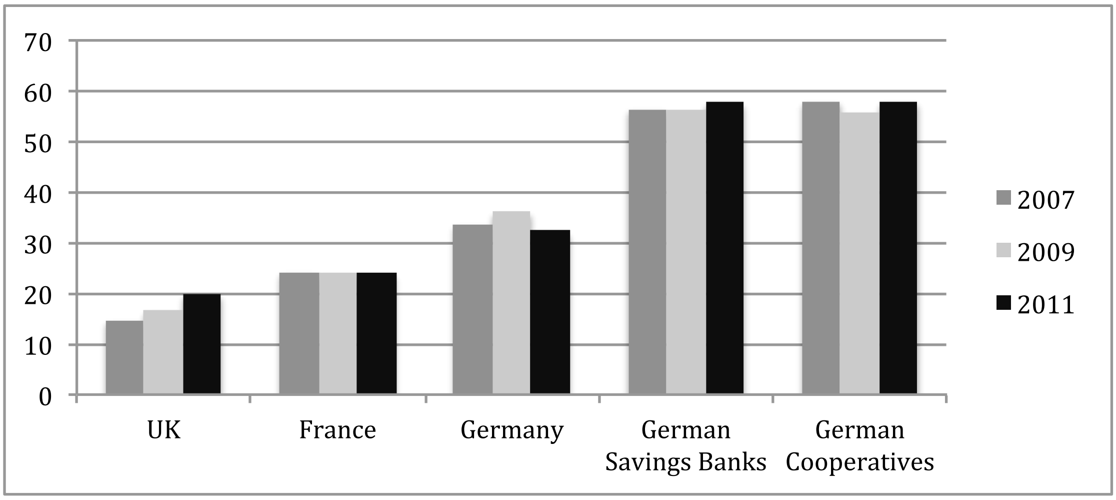
This section engages in a Comparative Political Economy analysis of Basel III by focusing on three core features of national financial / banking systems in our three European countries. Our analysis first considers relative internationalization, identifying three kinds of ‘banking champions’. This is followed by an examination of the capital position of banks and their funding models. Our analysis then considers the relative reliance of non-financial companies on bank credit for their external funding needs and the bank-industry relationship. Other features of banking systems, such as bank funding (liabilities), are more of an issue for the liquidity rules in Basel III, which are not examined here

To summarize, each banking system reflects key features of the national Variety of Capitalism. The UK banking system is dominated in part by three ‘international champions’: highly internationalized and well-capitalized institutions with a comparatively limited presence – in terms of their total assets – in the domestic economy. The French banking system is dominated by ‘national champions’ which have an important international profile but retain a strong domestic presence. French banks are less well capitalized than their British counterparts and they rely more on domestic retail banking. The German banking system is both the least concentrated in Europe and the least internationalized of the three. Although Germany is home to two very big, highly internationalized, commercial banks – Deutsche Bank and Commerzbank – there are also thousands of undercapitalized public and small local banks which provide the bulk of funding to, and maintain close relations with, small and medium sized enterprises. These banks are Germany’s ‘local champions’.

4.1 International, national and local champions

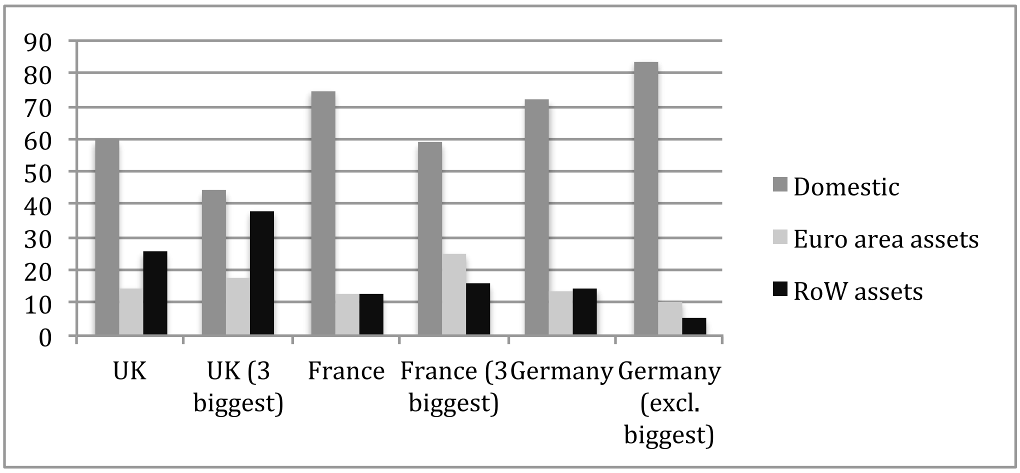
The internationalization of national banking systems is measured as the percentage of international versus domestically held bank assets and the relative importance of domestic bank lending to the overall activities of banks. Domestic lending forms only a small part of most of these banks’ assets (Figure 1). The three largest UK-headquartered banks are major international players and were among the world’s ten largest banks in terms of asset size throughout most of the 2000s. All three held a majority of their assets internationally and a large majority of these international assets beyond Europe (Figure 2). During the international financial crisis, the British Government required two of the banks (RBS and Lloyds-HBOS) to accept state funding (with share purchase reaching 78 per cent for the former and 18 per cent for the latter) but intervention in bank management was minimal and ‘nationalization’ was officially presented as being limited in duration (Woll and Grossman 2013).

Figure 1 Loans from banks to domestic NFCs and households / Total bank assets (percentage)



Sources: Data from Bank of England, Banque de France and Bundesbank databases, authors' own calculations.

Figure 2 Bank internationalization (per cent of total bank assets, 2007-2011 average)



Sources: Bank of England, Banque de France, Bundesbank statistical databases. Registration documents for Royal Bank of Scotland, Barclays, HSBC, BNP Paribas, Crédit Agricole and Société Générale. Notes: The three largest Germany-headquartered banks (measured by assets) became two with the forced merger of Dresdner and Commerzbank.

Only two of the five largest French banks hold more than 25 per cent of their assets outside the country (Figure 2). One recent study on European banking systems categorizes three of the five largest French banks as 'domestic', one regional and one 'semi-international' (banks with international operations reaching 25-50 per cent of total operations) (Schoenmaker and Peek 2014). While all five have significant assets outside the country, they rely on average considerably more on domestic retail banking than the largest UK-headquartered banks (Figure 1). The three main features of the French banking system – a combination of domestic focus, significant international presence and a high level of banking system concentration[11] – owe directly to state intervention. In the 1980s and 1990s, French conservative governments encouraged the emergence of a limited number of large, vertically integrated banking groups controlled by French corporate shareholders, in a complex network of cross-shareholding with national firms – including insurance companies – both to improve the stability of the system and to foster national champions – a reflection of longstanding industrial strategy (Cohen 1995; Hayward 1995; Schmidt 1996). Morin (2000, p. 37) has labeled this the 'financial network economy'.

The *bancassurance* model, in which insurance companies (often subsidiaries of banks) make use of banks to market their products, was also encouraged by state intervention through tax regimes (see Howarth, 2013 for further details). A range of explicit and implicit forms of protectionism were maintained which promoted the retail focus of some French banks. There is a caveat to this picture of a protectionist French banking system. Within a few years of privatization, the cross-shareholding networks began to unravel and foreign control of the largest national banks increased (Clift, 2007; Culpepper, 2005; Maclean *et al.*, 2001). Although French banks dominated the domestic banking system, the actual equity ownership of the two large commercial banks became increasingly foreign owned in the 1990s and 2000s. Despite the decline in cross-shareholding portfolios, important features of the 'financial network economy' remained (Clift, 2012; Dudouet and Grémont, 2010), including shareholding pacts as between BNP Paribas and the insurance giant AXA.

The German banking system was among the least internationalized in Europe and, by a significant margin, the least concentrated.[12] Only the two largest German commercial banks could be described as major international players. The bulk of bank assets were nationally held with the exception of the biggest two (Figure 2) and a small number of other commercial banks. The German banking system was a central pillar of the country's Coordinated Market Economy (CME) by providing 'patient capital', either through cross-shareholding by the large commercial banks (which had declined significantly by the late 2000s) or 'relational banking' (Deeg, 2010; Hackethal, 2004). The German CME involved a strong reliance of non-financial companies on bank loans and a limited role for equity capital; a strong institutional link between banks and non-financial companies through formal bank representation on the board of large firms; and a long-term relationship of trust between the Mittelstand (SMEs) and their 'Hausbank' as a lender with a special responsibility. 'Relational banking' thus reflected and reinforced the crucial position of small retail banks in the German system. The Sparkassen and Cooperatives were local or regionally based banks with a vested interest in the local economy. Regional Landesbanken (LB) provided funding through loans to Sparkassen and these LB were in turn backed by regional (Land) governments – officially, until the elimination of new government guarantees on their borrowing from July 2005, and unofficially since. Land governments funded the LB through 'silent participations' – long-term debt.

The international, national and local character of bank champions influenced the preference of policy makers in the three countries as to the regulatory 'trilemma'. British regulators were the least pre-occupied by the economic implications of bank deleveraging and were more concerned as to the competitive position of their internationally-focused banks. But the stability of the behemoths of British banking – reflected in the size of bail-outs for two of the largest banks – was given priority. German regulators were most preoccupied with the economic implications of deleveraging and least with the implications of Basel III for the stability of the national banking system and the competitive position of their locally-focused banks. French regulators refused to accept the relevance of 'too-big-to-fail' for their five large systemically important banks (Noyer, 2010; *Financial Times*, November 16, 2009): they deprioritized financial stability in relative terms, while highlighting competitiveness and deleveraging concerns. However, our characterization of bank champions in the three countries as international, national or local only provides a partial explanation of national policy makers priorities in the regulatory 'trilemma'.

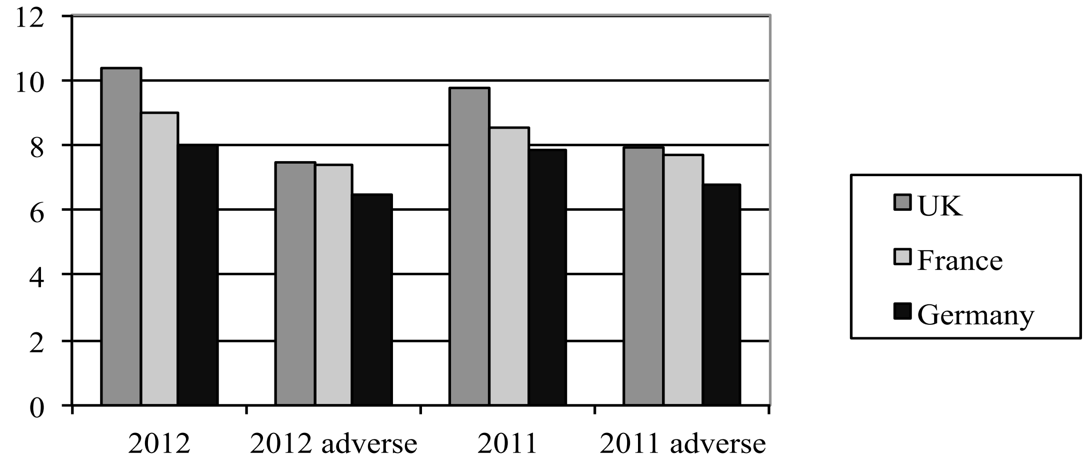
4.2 Bank capital position

The second key feature of national banking systems concerns the capital position of banks – principally their holding of equity and other Tier 1 capital – with a requirement to reach 6 per cent by 2015 and 8.5 per cent, with the capital conservation buffer by 2019. Institutions with higher capital ratios were in a competitively advantageous position because they were less likely to have to deleverage (cut their lending) or raise equity. The weak capital position of systemically important German banks helps to explain German regulator opposition to the rigid tightening of capital requirements (see Figure 3), while the biggest British banks would have limited difficulties to meet the Basel III standards. Clearly, early recapitalization (both public and private from 2007 to 2009) improved the capital position of British banks, giving them a massive leg-up in their ability to meet Basel III rules. For example, in its response to the BCBS consultation, Barclays (2010, p. 2) argued that 'we … have pre-empted the anticipated change by increasing our capital ratios in 2008-9 … whilst also lowering our leverage and improving our liquidity positions'.

With an eye to profitability and the competitive position, one senior British bank representative indicated that British banks would have preferred lower capital requirements, but also that ‘they could live with the new levels set in Basel III’ (interview, London, 15 March 2012). The British Bankers Association (BBA) expressed much stronger concerns in its documentation and official statements on Basel III. While tighter capital rules potentially strengthened the position of British banks in relation to undercapitalized European competitors, more stringent Basel guidelines, if adopted into EU legislation, could put British international bank champions at a competitive disadvantage in relation to non-European banks with headquarters in jurisdictions that either did not implement Basel III or did so only in part – notably the United States and China (Knight, 2010). The BBA called for a long transition period because of deleveraging pressures and the impact upon investor confidence in the event that banks retained earnings and cut dividends to share-holders to improve their capital position (*Financial Times,* 28 June 2011). British regulators thus effectively prioritized stability over the competition-related concerns of their biggest banks.

French and German banks had pressing concerns regarding the double counting of insurance subsidiaries, the use of hybrid capital and the inclusion of a leverage ratio. French bank data suggest their strong position but the double counting of capital in the banks’ insurance subsidiaries – to be banned under Basel III but allowed in the EU legislation implementing Basel III – inflates the figures. The IMF estimates that a ban on double counting would result in French banks losing a total of 28.9 per cent of their Tier 1 capital, preventing several from meeting the 6 per cent threshold and all from meeting the 8.5 per cent threshold – with the capital conservation buffer – from 2019 (IMF, 2011b). A ban would hit the three large French commercial banks particularly hard because of *bancassurance*. The French Banking Federation considered the BCBS proposal to exclude insurance subsidiary capital from Tier 1 capital as ‘completely unacceptable’ (Fédération Bancaire Française, 2010, p. 5). The French government then fought against the inclusion of the ban on double counting in EU capital requirements legislation. The *bancassurance* system predominates in certain other EU member states, including Spain and Austria. At least one British bank, the part state-owned Lloyds-TSB was also potentially exposed, as it is one of Britain's largest insurance providers.

Figure 3: Tier 1 capital (as a percentage of total assets) main British, German and French systematically important banks (non-weighted average)*

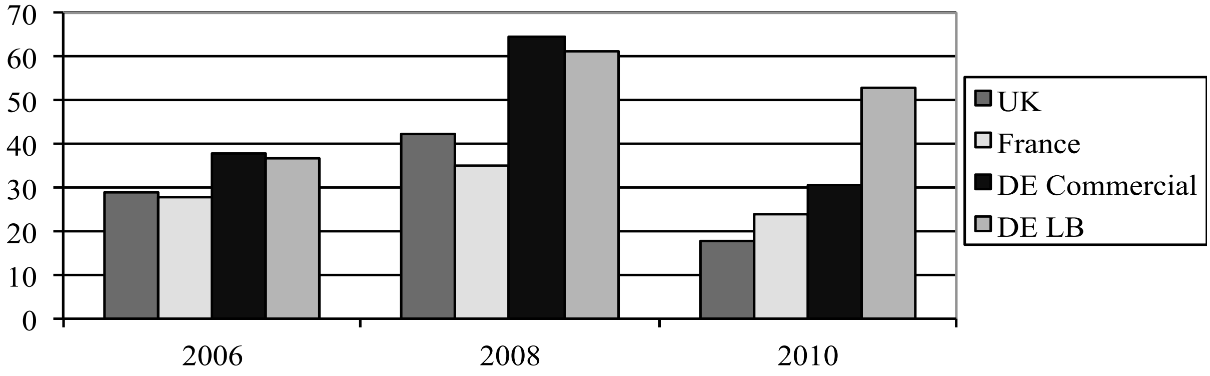


Sources: EBA. Stress tests undertaken in 2010 and 2011. Recall: Target of 8.5% in 2015 (including capital conservation buffer); 11% in 2019 with discretionary buffer. *Including some hybrids ('silent participations' only) and double counting of insurance subsidiary capital. Results of the stress test based on the full static balance sheet assumption without any mitigating actions, mandatory restructuring or capital raisings post 31 December 2010 (all government support measures fully paid in before 31 December 2010 are included). UK banks: RBS, HSBC, HBOS (not 2010), Lloyds, Barclays. French banks: Société Générale, BNP Paribas, Crédit Agricole, Caisse d'Epargne (BPCE in 2010). Figures exclude Banques Populaires and Crédit Mutuel. German banks : Desdner (not 2010), Commerzbank, Deutsche bank.

Banks which did not use equity to fund their activities – public sector, cooperative and mutual banks – faced particular difficulties meeting the new capital guidelines. These banks previously relied on other forms of capital to meet Basel guidelines, notably hybrids and specifically 'silent participations'. The ban on hybrids would hit hardest the German banking system, given the heavy reliance of public and commercial banks on 'silent participations', while the large French mutuals were also exposed. Also, EU implementing legislation of the two previous Basel accords applied the rules to all EU-headquartered banks – not just the internationally active ones – on the grounds of fair competition in the EU internal market. Without significant dilution then, Basel III would force major changes to the German banking system. It is no wonder then that the peak association representing all German banks asked for a grandfathering clause on Basel III capital rules of 'at least 30 years' (Zentraler Kreditausschuss, 2010, p. 3) and the German government demanded the inclusion of 'silent participations' as acceptable Tier 1 capital in the EU capital requirements legislation (see also Deutsche Bank, 2010).

The strong opposition of French and German regulators to the use of a leverage ratio reflected the higher ratios of their large commercial banks (compared to the UK) and in particular the difficult situation facing German LB and Sparkassen and French mutual banks given the lack of equity capital (see Figure 4).[13] Basel III was written having in mind banks funded by equity finance (hence the emphasis on common equities in Core Tier 1 capital), whereas the external funding of many EU-based banks came from other sources. Despite the significant rise in their leverage ratios during the two years prior to the outbreak of the financial crisis, British banks had been among the least leveraged in the EU, well below the Basel III recommended assets to equity threshold of 33 (or equity to asset ratio of 3 per cent), holding on average over a third more equity as a percentage of assets than German banks (ECB Statistical data warehouse). On first examination, the three large French commercial banks appeared to have a similarly low leverage ratio but the ban on double counting would weaken their position.[14] The opposition of French and German banks and their regulators to a leverage ratio, as opposed to a calculation of risk-weighted assets, also reflects the relative importance of trade financing in their overall operations. Trade financing is high in terms of overall assets but low in terms of risk-weighted assets.

Figure 4: Leverage ratio for British, German and French systemically important banks (non-weighted average) (assets to equity)



Source: Bank balance sheets. UK banks: RBS, HSBC, HBOS (not 2010), Lloyds, Barclays. French banks: Société Générale, BNP Paribas, Crédit Agricole, Caisse d'Epargne (BPCE in 2010). Figures exclude Banques Populaires and Crédit Mutuel. German banks : Desdner (not 2010), Commerzbank, Deutsche Bank. German LB: HSH Nordbank, LB Berlin, LBBW, Heleba, Bayerische LB, West LB. (LB Sachsen excluded).

To conclude this section, the different capital position of banks in the three countries contributed to the different prioritization by national regulators of the elements of the regulatory trilemma. The stronger the capital position of banks, the weaker the concern with the impact of Basel III upon the real economy. A weaker capital position corresponded to greater concerns about the competitiveness of national banks and the impact of Basel III rules on the wider economy. In a race to the top, the new rules could provide a competitive advantage to British banks, which had a head-start on capital and liquidity. However, this should not suggest that British banks promoted more stringent guidelines: they did not. They focused on their profitability and their competitive position in relation to even better capitalized US banks or banks in jurisdictions that were unlikely to apply Basel III in full. The British example demonstrates that competitiveness can be a trickier issue than much of the literature on 'regulatory arbitrage' and on the dilemma between stability and competitiveness suggests. With regard to capital requirements, and potentially other areas of banking regulation, competitiveness in relation to whom becomes relevant: Basel III promised to make the big British banks more competitive in relation to many EU-headquartered banks but also threatened their competitveness in relation to banks elsewhere.

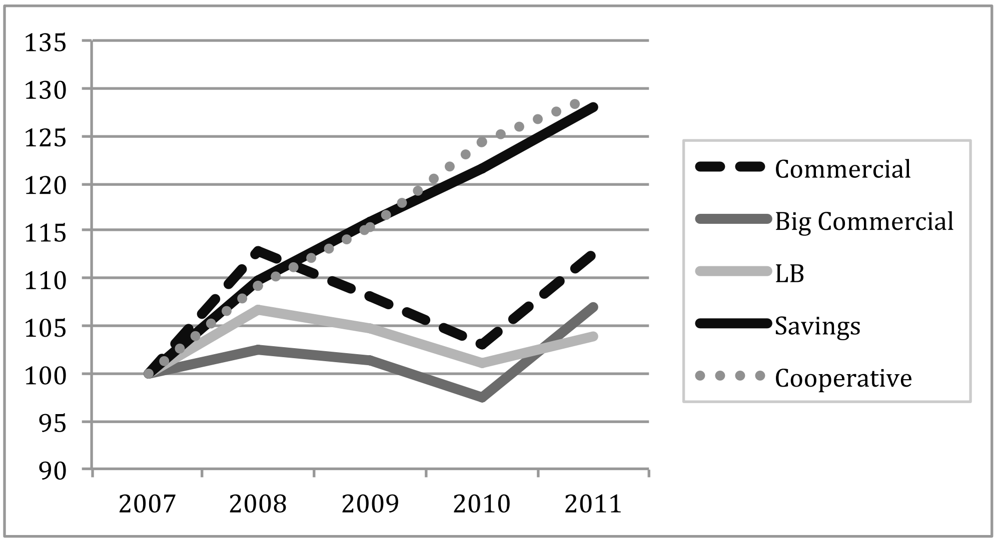
4.3 Bank-industry ties

The third key feature of national financial systems that helps to explain the prioritization of objectives in the regulatory 'trilemma' concerns bank-industry ties. In countries with less developed equity markets and greater reliance on bank credit, banks and more importantly national authorities were worried that tighter capital requirements would lead banks to reduce lending to industry. In most European countries there was relatively high dependence of non-financial companies (particularly, small and medium sized enterprises) on bank finance. Furthermore, in a number of European countries – notably France and the Netherlands – where equity issuance by non-financial companies had increased significantly in the 1980s and 1990s, the decade prior to the outbreak of the financial crisis in 2008 saw a rapid rise in the use of bank credit by non-financial companies (Hardie and Howarth 2013a). The long-standing close relations between banks and industry in several continental European countries reinforced deleveraging concerns.

In Germany, relational (*hausbank*) banking effectively shaped the preferences of both banks and regulators on capital requirements – in spite of changes in recent years (Deeg 2010). French non-financial companies' reliance on equity was comparatively high, although French small and medium sized enterprises were more dependent upon bank credit than their British counterparts – which helps to explain French sensitivities (Howarth 2013). UK non-financial companies also came to rely much more on bank credit for their funding in the decade prior to the financial crisis, a development encouraged by low interest rates and the securitization of bank loans.

Bank lending to non-financial companies in the UK dropped by twenty per cent between 2007 and 2011 (ECB Statistical data warehouse), a refection of the massive deleveraging of British banks and the collapse of securitization markets (Hardie and Maxfield 2013). By contrast, lending by German and French banks to non-financial companies remained relatively strong – down in 2009 by only 5 per cent for German banks from a 2008 peak and approximately 2 per cent for French banks (ECB Statistical data warehouse). Credit provision was limited principally by slow economic growth as opposed to the deleveraging efforts of banks. Forcing French and, more significantly, German banks to deleverage during a recessionary period could result in a credit crunch if banks reduced their lending (cut their risk-weighted assets denominator) instead of boosting their capital (lifting their equity numerator) which was likely given the difficulty of attracting capital. One IMF study from 2011 on the differential impact of Basel III rules on national banking systems echoes findings in a range of other studies: to demonstrate a particularly significant impact upon bank lending in Germany and a comparatively small drop in the UK, with France somewhere in between (Cosimano and Hakura, 2011). A BCBS study (2010c) noted differential impact but refused to be specific on countries. While in France, the 'national' champions maintained lending to the real economy in the years following the international financial crisis, in Germany, the comparatively stable levels of bank lending owed principally to the 'local champions' while the big internationally-active commercial banks cut their lending considerably (Figure 5).

Figure 5: Change in German Bank Lending to Domestic Non Financial Companies, 2007-2011 (2007 = 100)



Source: Deutsche Bundesbank. The big commercial banks include: Deutsche Bank, Commerzbank, HypoVereinsbank (HVB) (now part of the Italian UniCredit Bank), Postbank and, prior to 2009, Dresdner Bank.

To conclude this section, the systemic features of bank-industry relationships in the three countries contributed to the different prioritization by national regulators of the three elements of the regulatory trilemma. The Germans were mindful of the effects of stricter capital rules on economic growth given the stronger domestic bank-industry relationship. While bank-industry ties were weaker in France, the relative importance of domestic retail activities (compared to international activities) of the largest French banks contributed to the government's focus upon the economic implications of tighter capital requirements. For British regulators, the looser bank-industry relationship in the UK undermined the prioritization of domestic lending (Macartney 2013). Similarly, the Conservative-led government's ambitious bank lending targets – enumerated in Project Merlin – were not met and lending by all the biggest British banks dropped in every quarter of 2011.

5. Conclusions

This paper has argued that a Comparative Political Economy analysis focused on the configuration of national banking and financial systems has considerable analytical leverage in accounting for the preferences of European regulators on Basel III, explaining the disagreements that emerged in Basel and ultimately the weakness of the reforms eventually agreed by the BCBS, despite the severity of the global financial crisis. National regulators faced a trilemma on financial / banking regulation, trying to achieve three different (at times hardly compatible) objectives. The distinctive configuration of national financial systems in Europe, to be precise three core features of national banking/financial systems, determined the ordering of national regulators' priorities on the trilemma (see Table 2) and ultimately on Basel III. The different prioritization of British, French and German regulators remained consistent from 2009 through to the transposition of the Basel III guidelines into EU law in 2013.

Table 2 The Regulatory Trilemma: Prioritizing Stability, Competitiveness and the Real Economy

	Stability	**Competitiveness**	**Real Economy**
UK	1	2	3
France	3	2	1
Germany	2	3	1

Table 3 Banking System Features and Preference on Capital Requirements

Independent Variable	Banking System Feature	Objective prioritized / deprioritized	Preference on Basel III capital requirements / definition
Capital Level	Higher	Not the real economy	Higher / Tighter
	Lower	real economy concerns	Lower / Looser
Internationalization	Higher	competitiveness / stability (post crisis)	Higher / Tighter
	Lower	real economy concerns	Lower / Looser
Non-bank source of NFC funding	Higher	Less concern with impact on real economy	Higher / Tighter
	Lower	real economy concerns	Lower / Looser

The main findings of this research can be generalized to other cases (i.e., countries). The (inductive) analytical framework centred on three core features of national banking / financial systems can be wielded to explain the preferences of policy makers in other countries on Basel III and, potentially, their priorities on other areas of bank regulation (see Table 3). In countries, such as Germany, where strong bank-industry ties persist, policy makers will prioritize the economic growth leg of the trilemma, especially when banks have a weak capital position and thus stricter capital rules will be detrimental to lending to the real economy. In countries, such as the UK and the US, with weaker bank-industry ties, economic growth will be the less important leg in the trilemma for policy makers, especially if domestic banks start with a good capital position.

In countries, such as Germany, where the banking system is characterized by a low degree of internationalization and concentration, policy makers will be the least concerned about the competitiveness leg of the trilemma. Their local champions are unlikely to face fierce foreign competition domestically and national policy makers might use a range of instruments to make difficult foreign penetration into the domestic market. In countries, such as France, that have national champions that aspire to be international (or at least regional / European) champions, national policy makers will prioritize the competitiveness leg of the trilemma. In countries, such as the UK and the Netherlands, that have an internationalized and concentrated banking system with big international champions, policy makers will rank competitiveness high, but not as high as countries (notably France), where policy makers aspire to develop international champions. Post financial crisis, the presence of international banks 'too big to fail' but also 'too big to be rescued' – as in the UK, the Netherlands and Switzerland – encourages national policy makers to prioritize the stability leg of the trilemma, at least in the short to medium term. In a period of 'quiet politics' (Culpepper 2011), policy makers in countries with international champions will rank competitiveness first.

Finally, it is worth noting that the trilemma concept has implications for future work on international and domestic financial regulation. It alerts scholars to the need to pay attention to the effects of financial regulation (especially banking regulation) upon economic growth, bearing in mind the configuration of national banking and, more generally, financial systems and their links to the real economy. The concept contributes to explaining the politics of international financial regulation, in particular why devising international rules is fraught with difficulties: different countries have different priorities in the trilemma and face different trade-offs.

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Endnotes

[1] When the financial crisis broke out the US had not yet implemented Basel II into national legislation.

[2] Woll's (2014) and Grossman and Woll's (2013) excellent studies are focused on the leeway that governments had in designing bank bailouts.

[3] Throughout this article we use the term 'regulators'. This is standard in the literature on the BCBS. However, it is understood that these 'regulators' are in fact representatives from supervisory bodies, many of whom have limited or no regulatory power at the national level

– unlike US supervisors who also possess significant autonomous regulatory powers. In the context of the BCBS, however, these supervisors gain decision-making power over the setting of the Basel guidelines.

[4] Given limited space in this article, a large number of bank association and individual bank positions on Basel III is presented on the *Socio-Economic Review* website.

[5] Given limited space in this article, a number of useful tables and figures demonstrating the capital position of banks in three countries and estimates on the impact of Basel III from the 2009-2011 period are provided on the *Socio-Economic Review* website.

[6] We do not consider the Basel III liquidity guidelines in this paper given limited space but we recognise that they are an important dimension of the attempt to reinforce bank stability.

[7] Hybrids are instruments that have some features of both debt and equity.

[8] Tier 2, or supplementary capital, consists of undisclosed reserves, revaluation reserves, general provisions and subordinated term debt.

[9] This buffer is intended to promote the conservation of capital and the build-up of adequate buffers above the minimum that can be drawn down in periods of stress.

[10] For example, the working group on liquidity was chaired by Nigel Jenkinson of the Bank of England; the working group on the trading book was chaired by Alan Adkins of the British Financial Services Authority.

[11] In France, the five largest banks held approximately half of total bank assets (47.2 per cent in 2009, down from 51.9 per cent in 2005) (ECB 2010: 36).

[12] In Germany, the five largest banks held 25 per cent of total bank assets in 2009 (ECB 2010: 36).

[13] For example, the Zentraler Kreditausschuss rejected the concept of the leverage ratio (2010, p. 30) and the Fédération Bancaire Française wanted to limit the use of the leverage ratio to Basel Pillar II (2010, p. 2).

[14] The largest French bank, BNP Paribas, argued that the 'leverage ratio…has proven failures [sic] or flawed definitions wherever it has been applied, in particular in the US. Application should be based at most on a pillar 2 approach' (2010, p. 2).